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Defining the "Economic Interest" in Minerals After *United States v. Swank*

BY MARTIN J. MCMAHON, JR.*

INTRODUCTION

The concept of "economic interest" is the fundamental principle governing taxation of the mineral industry: it is the touchstone which determines both the allocation of gross income¹ and entitlement to either cost or percentage depletion;² it is also a key element in ascertaining whether a mineral interest has been sold rather than leased.³ The term first appeared in the 1933 Supreme Court decision of *Palmer v. Bender*,⁴ where the Court ascribed to it a definition which has since been incorporated into the treasury regulations as follows:

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.⁵

This definition generally remains the starting point for any discussion of economic interest. Yet, despite its seemingly concrete language, the cases reveal that this traditional definition is frequently very difficult to apply.

One reason for the difficulty in articulating a workable definition is the divergent types of mineral interests against which

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¹ *Anderson v. Helvering*, 310 U.S. 404 (1940); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934).

² *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Thomas v. Perkins*, 301 U.S. 655.

³ *Palmer v. Bender*, 287 U.S. 551 (1933); *Burnet v. Harmel*, 287 U.S. 103 (1932).

⁴ 287 U.S. 551, 557 (1933).

⁵ Treas. Reg. § 1.611-1(b)(1), T.D. 7261, 1973-1 C.B. 309, 317.

the definition must be applied. The substantive rights and concomitant risks of nonoperating interests are frequently so different from those of operating interests that tests applicable to one type of interest may be meaningless when applied to the other. Unfortunately, the courts have not always clearly recognized this problem. Consequently, courts consistently treat the terminology of the traditional definition as a string of words of art, finding its factors satisfied by ascribing to its terms meanings which no lexicographer could fathom. Notwithstanding their consistent restatement of the traditional definition and purposes of the depletion allowance,⁶ courts with equal frequency conclude either that no investment is necessary or that an investment in the mineral may be found in an investment in property which is recoverable as an expense or through depreciation. Thus, in applying the definition of an economic interest the courts, like Humpty Dumpty, take the attitude, "When I use a word . . . it means just what I choose it to mean. . . ."⁷

Despite the elusiveness of a truly workable definition, the courts have, with some exceptions, generally reached satisfactory results in determining whether a taxpayer in fact has an economic interest. One such exception encompasses operating interests in coal and certain other hard minerals. The problem is manifest in two fairly typical arrangements in the coal industry—contract mining and leases terminable on short notice without cause. Although the question of whether a particular taxpayer is a contract miner or a lessee remains a subject of litigation, the proper treatment of contract miners has generally been considered to have been resolved by the Supreme Court in *Parsons v. Smith*⁸ and *Paragon Jewel Coal Co. v. Commissioner*,⁹ which held that contract miners have no economic interest in the coal in place and thus are not entitled to depletion. On the other hand, until the recent decision of the Supreme Court in *United*

⁶ See text accompanying note 49 *infra* for an example of the traditionally stated purpose of the depletion allowance.

⁷ L. CARROLL, *Through the Looking Glass* in THE COMPLETE WORKS OF LEWIS CARROLL 196 (1966).

⁸ 359 U.S. 215 (1959).

⁹ 380 U.S. 624 (1965).

States v. Swank,¹⁰ courts were divided as to whether a lessee under a lease terminable by the lessor without cause on short notice had such an economic interest. With *Swank* the Court resolved this issue, holding that where the lessee would otherwise have had an economic interest in the coal in place, the mere existence of an unexercised termination clause will not deprive the lessee of that economic interest.

This article will examine the definition of an economic interest in light of the *Swank* decision, propose a definition of economic interest which better comports with reality, particularly when applied to operating interests in hard minerals, primarily coal, and examine the continued validity of *Parsons v. Smith* and *Paragon Jewel Coal Co.* under the proposed definition.

I. THE SWANK DECISION

United States v. Swank involved three separate refund suits, consolidated for argument in both the Court of Claims and the Supreme Court.¹¹ The facts in each case were essentially the same. Each taxpayer operated a coal mine under a written lease and had the right to extract and sell the coal for his own account; the lessor exercised no supervision of the operation, but received a fixed royalty per ton of coal extracted. All of the leases provided for unilateral termination by either party without cause upon thirty days' prior notice, but in no instance was the right of termination exercised. The taxpayer in each case operated under the lease for several years, in two of the three cases mining the leased coal to exhaustion.

In each case the taxpayer claimed percentage depletion on his gross income from mining, less royalties paid to the lessor.¹²

¹⁰ 101 S. Ct. 1931 (1981).

¹¹ *Swank v. United States*, 602 F.2d 348 (Ct. Cl. 1976), *aff'd*, 101 S. Ct. 1931 (1981) (also deciding *Black Hawk Coal Corp. v. United States* (Ct. Cl. 1976) & *Bull Run Mining Co. v. United States* (Ct. Cl. 1976)).

¹² Depletion is generally allowed under I.R.C. § 611 (1976) with respect to "mines, oil and gas wells, other natural deposits, and timber." I.R.C. § 612 (1976) provides that the basis on which depletion is allowed is the adjusted basis of the property unless percentage depletion as provided in I.R.C. § 613 (1976) is elected.

Percentage depletion is allowable for coal at the rate of 10%. I.R.C. § 613(b)(4) (1976). The specified percentage is applied against "the gross income from the property ex-

The Commissioner disallowed the deduction, asserting that the taxpayer had no economic interest in the coal in place. The government conceded, however, that each taxpayer would have had an economic interest but for the termination provision and thus would have been entitled to the depletion allowance.¹³

The government advanced two theories to support its position that terminability of the leases deprived the lessees of an economic interest. First, it argued that the termination clause afforded the taxpayers a "mere economic advantage"—distinguished by the regulations from a depletable economic interest—akin to the mining contractors in *Parsons v. Smith* and *Paragon Jewel Coal Co.*¹⁴ Second, the government argued that "as a matter of 'practical economics' . . . the right to terminate gives the lessor the only significant economic interest in the coal."¹⁵ The premise underlying this argument was that the lessor retained the

cluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." I.R.C. § 613(a) (1976). For a general discussion of the meaning of "gross income from the property," see *Determination of Gross Income and Taxable Income From Oil and Gas Wells*, OIL & GAS—NAT. RESOURCES (P-H) ¶ 2024 (1978), and Maxfield, *Gross Income From Mining*, OIL & GAS—NAT. RESOURCES (P-H) ¶ 2034 (1979).

Depletion is to be equitably apportioned between the lessor and lessee under I.R.C. § 611(b)(1) (1976). Lessees, however, were permitted to deduct depletion prior to the enactment of the predecessor of I.R.C. § 611(b)(1) (1976). *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364, 369 (1925).

¹³ 602 F.2d at 349.

¹⁴ *United States v. Swank*, 101 S. Ct. at 1937. Treas. Reg. § 1.611-1(b) provides in part:

A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest.

Treas. Reg. § 1.611-1(b), T.D. 7261, 1973-1 C.B. 309, 317. The "mere economic advantage" limitation imposed by the regulation arose from the Supreme Court's decision in *Helvering v. Bankline Oil Co.*, 303 U.S. 362, which held that a processor of wet gas had no economic interest. See Treas. Reg. 118, § 39.23(m)-1(b) (1954). See text accompanying notes 73-75 *infra* for a discussion of *Helvering v. Bankline Oil Co.* The example of a contract entitling the taxpayer to "compensation for extraction" was added following the Supreme Court's decision in *Parsons v. Smith*, 359 U.S. 215. See Treas. Reg. § 1.611-1(b), T.D. 6446, 1960-1 C.B. 208, 211.

¹⁵ 101 S. Ct. at 1937.

right to the benefit of future increases in the market price of coal through his ability to terminate the lease and negotiate a new lease with another or the same lessee at a royalty commensurate with the then-prevailing market price. Both of these arguments were rejected by the Court, which held that the taxpayers had a depletable economic interest.¹⁶

The Court distinguished *Parsons v. Smith* and *Paragon Jewel Coal Co.* on the basis that the terminability of the contract miners' agreements was not determinative in those cases. Although terminability was enumerated in *Parsons v. Smith* as one of seven factors indicating the lack of an economic interest, the *Swank* Court concluded that the same result would have followed in both *Parsons v. Smith* and *Paragon Jewel Coal Co.* absent terminability.¹⁷ As analyzed by the *Swank* Court, the distinguishing factor depriving the contract miners of a depletable economic interest was that they were merely to mine the coal for delivery to the owner or lessee at a fixed price; the miners therefore had neither any right to sell the coal to a third party after extraction nor any other interest in the coal before or after it was mined.¹⁸ Thus, because the contract miners looked solely to fulfillment of the contract terms, rather than to the sale of the coal, for a return of their investment, they did not meet the *Palmer v. Bender* test of an economic interest.¹⁹ In contrast, the lessees in *Swank* had a legal interest in the mineral both before and after it was mined and were free to sell the coal at the market price.²⁰

The Court also rejected the government's second theory, enumerating three reasons for doing so. First, on the basis that the factors influencing the level of royalty payments were so numerous that an increase in the market value of coal would not necessarily result in the lessors' terminating the lease for the purpose of renegotiating for a higher royalty, the Court concluded that the lessees' interests were not economically illusory.²¹ That the lessor did not in fact retain control of the deposit was evi-

¹⁶ *Id.* at 1939.

¹⁷ *Id.* at 1937.

¹⁸ *Id.*

¹⁹ *Id.* at 1938.

²⁰ *Id.*

²¹ *Id.* at 1939.

denced by the fact that the leases continued in force for many years even though the value of the coal increased markedly.²² Thus the lessees met both halves of the test of an economic interest under the regulations which require, first, that the taxpayer have a capital interest in the mineral in place and, second, that the taxpayer look only to the extraction and sale of the mineral for a return of his capital.²³

Second, the Court was influenced by the seeming unfairness of penalizing the taxpayer by denying the deduction merely because he assumed the risk of termination, a risk which a lessee under a long-term lease has not assumed, when in all other respects the two were in the same position. The Court concluded that it was unlikely that Congress intended to so penalize taxpayers because of their unequal bargaining power.²⁴

Finally, and of most importance to the Court, considerations of tax policy militated against the government's position. In analyzing the policy underlying the percentage depletion allowance, the Court in *Swank* finally acknowledged that the allowance is not merely a capital recovery provision, but also a special benefit to encourage the extraction of minerals.²⁵ Consequently, there should be no difference "whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods."²⁶ Accordingly, the Court could find no logical reason to deny depletion to the lessee under a lease terminable on short notice. In addition, to do so would be contrary to the policy behind the percentage depletion allowance since the result if the lessee were denied depletion would be that no party would be entitled to the allowance.²⁷

Dissenting, Justice White, joined by Justice Stewart, disagreed with the majority's conclusion that the ownership of the coal after extraction and the right to sell the coal at the market price were sufficient to confer an economic interest on the les-

²² *Id.*

²³ *Id.* at 1937. See Treas. Reg. § 1.611-1(b), T.D. 7261, 1973-1 C.B. 309, 317.

²⁴ 101 S. Ct. at 1939.

²⁵ *Id.* at 1935.

²⁶ *Id.* at 1939.

²⁷ *Id.* at 1935-36.

sees.²⁸ The dissent emphasized that the *Parsons v. Smith* multiple factor test was not solely dependent on the marketing scheme and, therefore, should not be so distinguished.²⁹ Rather, the dissent accepted the position of the Internal Revenue Service that the single factor of short notice terminability should be determinative, noting that such a position was entitled to deference as a longstanding administrative interpretation of the regulations.³⁰

Further, the dissenting opinion did not view actual continued operation under the lease as overcoming the lack of a legal right to mine for more than thirty days.³¹ The lessees' "rights," therefore, whether to the mineral in place or to sell the extracted mineral at the market price, were illusory because solely dependent on the lessor's willingness to continue the lease.³² Such illusory rights did not meet the Service's requirement of some enforceable expectation of continuity in mining rights as a prerequisite for asserting an economic interest in the mineral in place.³³

While a narrow reading of *Swank* may confine its holding to merely the terminability issue, the method of analysis used by the Court—particularly its emphasis that furthering the policy behind the percentage depletion allowance is relevant in determining whether the taxpayer has an economic interest—raises broad questions concerning the viability of the traditional definition of an economic interest. In analyzing the interest of the taxpayers, the Court did not directly apply the bifurcated test of the regulations. Due to its policy orientation, the Court's analysis was concentrated instead on a modified version of the second half of that test, finding an economic interest where the taxpayer derived income from the extraction and sale of the mineral. Further, in dis-

²⁸ *Id.* at 1939 (White, J., dissenting).

²⁹ *Id.* at 1944 (White, J., dissenting).

³⁰ *Id.* at 1940-42 (White, J., dissenting). This generally accepted doctrine was not discussed in the majority opinion, which *sub silencio* overturned—in part—the definition of an economic interest in Treas. Reg. § 1.611-1(b)(1). For the relevant text of Treas. Reg. § 1.611-1(b)(1), see text at note 5 *supra*. For a brief discussion of the weight to be accorded treasury regulations and of the standards for overturning them, see McMahon, *Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine*, 67 IOWA L. REV. 31, 57 n.85 (1981).

³¹ *United States v. Swank*, 101 S.Ct. at 1943-44 (White, J., dissenting).

³² *Id.* at 1944 (White, J., dissenting).

³³ *Id.* (White, J., dissenting).

tinguishing *Parsons v. Smith*, the Court failed to analyze fully the effect of its holding on the first half of the test, requiring a capital interest in the mineral in place. Indeed, the Court's approach was similar to that of Justice Stewart when he attempted to analyze the concept of obscenity:³⁴ although it did not attempt to fully define the substantive rights embraced by the term "economic interest," the Court knew it when it saw it. Recognizing the interest of the taxpayers in *Swank* as an economic interest, however, effects a change in the substantive rights embraced by the term which requires a redefinition. After *Swank*, the first half of the traditional definition is of substantially diminished importance and the second half of the definition, which previously evoked a less thorough examination than the first half of the definition, ascends to primacy.

This article will examine the history of the statutory provisions for depletion as well as the early cases from which evolved the general language delineating the parameters for defining an economic interest, for those cases contain the seeds of the confusion over the definition. Only then can one understand that the decision in *Swank* signals a change in the theoretical basis for determining whether a taxpayer has an economic interest entitling him to depletion, rather than merely resolving the issue of the effect upon depletion of termination clauses in mineral leases and partially clarifying the relative importance of the seven factors in *Parsons v. Smith*.

II. THE SEEDS OF CONFUSION: THE EARLY STATUTORY PROVISIONS AND THE DEVELOPMENT OF THE TEST FOR AN ECONOMIC INTEREST

An allowance for depletion has been part of the modern income tax laws from their inception. The Tariff Act of 1913 permitted deduction of "a reasonable allowance for depletion of ores

³⁴ *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1963). In the *Jacobellis* decision, Justice Stewart, struggling with the definition of obscenity, stated:

I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description and perhaps I could never succeed in intelligently doing so. But I know it when I see it, and the motion picture involved in this case is not that.

and all other natural deposits, not to exceed five percent of the gross value at the mine of the output for the year for which the computation is made.”³⁵ The Revenue Act of 1916 extended depletion to oil and gas wells and provided for depletion with respect to mineral properties purchased prior to March 1, 1913 in an aggregate amount not to exceed the fair market value of the property as of that date.³⁶ The 1916 Act was intended to permit only recoupment of cost, however, and limited aggregate depletion of properties purchased after March 1, 1913 to an amount equal to the taxpayer’s cost basis.³⁷ Under these early statutes depletion was truly akin to depreciation and the Supreme Court’s explanation of the purpose of depletion in *United States v. Ludey*³⁸ accurately reflected the policy underlying the allowance:

The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed.

. . . The proviso limiting the amount of the deduction for depletion to the amount of the capital invested shows that the deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks.³⁹

The Revenue Act of 1918 began an evolution in the purpose

³⁵ Tariff Act of 1913, ch. 16, § II G(b), 38 Stat. 114, 172-73 (applicable to corporations); Tariff Act of 1913, ch. 16, § II B, 38 Stat. 114, 167 (applicable to individuals).

³⁶ Revenue Act of 1916, ch. 463 §§ 5(a) Eighth, 12(a) Second, 39 Stat. 756, 759, 767-68.

³⁷ *Id.* The 1913 Act, on the other hand, did not necessarily ensure full recovery of cost because of the limitation of depletion annually allowable to 5% of the value of the output; cost in excess of that amount was not recoverable. Tariff Act of 1913, ch. 16, § II G(b), 38 Stat. 114, 172-73; Tariff Act of 1913, ch. 16, § II B, 38 Stat. 114, 167. *See also* *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 113-14 (1916).

³⁸ 274 U.S. 295 (1927).

³⁹ *Id.* at 302-03.

of the depletion allowance by liberalizing the amount of aggregate depletion allowable as follows:

[I]n the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter. . . .⁴⁰

Quite clearly, the intended effect of this change was to stimulate exploration and development of new mineral properties.⁴¹ No longer was the depletion deduction necessarily akin to the cost of goods sold or the allowance for depreciation. While the purchaser of a proven property was allowed depletion based on cost—presumably equal to the fair market value at the date of purchase, the discoverer of minerals, oil, or gas was entitled to a deduction which could be many times his cost. Thus, there was a marked difference in purpose between the March 1, 1913 fair market value depletion allowed by the Revenue Act of 1916 and the generally applicable discovery value depletion of the Revenue Act of 1918. While the former provision was quite possibly

⁴⁰ Revenue Act of 1918, ch. 18, § 214(a)(10), 40 Stat. 1057, 1066-68 (applicable to individuals); Revenue Act of 1918, ch. 18, § 234(a)(9), 40 Stat. 1057, 1077-78 (applicable to corporations).

⁴¹ Discovery value depletion originated in the Senate version of the Revenue Bill of 1918. The rationale was explained as follows:

The prospector for mines or oil and gas frequently expends many years and much money in fruitless search. When he does locate a productive property and comes to settle it seems unwise and unfair that his profit be taxed at the maximum rate as if it were ordinary income attributable to the normal activities of a single year. To stimulate prospecting and exploration, the committee has limited the surtax to 20 per cent of the selling price in the case of a bona fide sale of mines, oil or gas wells where the principal value was demonstrated by prospecting, exploring, or discovery work done by the taxpayer. . . . Special provision is also made for increased depletion allowance in the case of such properties.

S. REP. NO. 617, 65th Cong., 3d Sess. 6 (1918), *reprinted in* 1939-1 C.B. (pt. 2) 117, 120-121. See C. GALVIN, *THE DEDUCTION FOR PERCENTAGE AND EXPLORATION AND DEVELOPMENT COSTS*, 2 HOUSE COMM. ON WAYS & MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM 933, 942 (Comm. Print 1959); Austin, *Percentage Depletion: Its Background and Legislative History*, 21 U. KAN. CITY L. REV. 22, 25-26 (1952); Baker, *The Nature of Depletable Income*, 7 TAX L. REV. 267, 270-71 (1952).

intended to avoid any issues of unconstitutionality,⁴² the latter provision is an excellent example of an early "tax expenditure" item.⁴³

Discovery value depletion proved to be unworkable for several reasons, including the difficulty of estimating the value of the deposit and determining who was a discoverer of an unproven reserve.⁴⁴ Because these problems were particularly acute with respect to oil and gas, the Revenue Act of 1926 revised the depletion allowance as applicable to those resources.⁴⁵ Discovery value depletion for oil and gas wells was abandoned, and in its place was substituted a flat percentage deduction of 27.5% of the gross income from the property.⁴⁶ Although the depletion allowable annually was limited to fifty percent of taxable income and reduced the taxpayer's basis in the property (although not below zero), the limitation on aggregate depletion deductions was removed. The Revenue Act of 1932 accorded similar treatment, at lower rates of depletion, to metals, coal, and sulphur.⁴⁷ Percentage depletion was subsequently extended to a wide range of natural resources.⁴⁸

⁴² Cf. S. REP. NO. 793, pt. 1, 64th Cong., 1st Sess. (1916), *reprinted in* 1939-1 C.B. (pt. 2) 28, 30 (fixing basis for gain on property acquired before March 1, 1913, as the fair market value on that date).

⁴³ For a brief explanation of the definition of a tax expenditure, see Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. IND. & COM. L. REV. 679, 682-88 (1976). The excess of percentage depletion has been treated as a tax expenditure under the Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297. See, e.g., Budget of the United States Government, 1979, Special Analysis G, Table G-1. The theory of discovery depletion is implicit in percentage depletion. See Baker & Griswold, *Percentage Depletion—A Correspondence*, 64 HARV. L. REV. 361, 370 (1951).

⁴⁴ S. REP. NO. 52, 69th Cong., 1st Sess. (1926), *reprinted in* 1939-1 C.B. (pt. 2) 332, 345-46; Austin, *supra* note 41, at 26-27.

⁴⁵ H.R. REP. NO. 356, 69th Cong., 1st Sess. (1926), *reprinted in* 1939-1 C.B. (pt. 2) 361, 362-63; S. REP. NO. 52, 69th Cong., 1st Sess. (1926), *reprinted in* 1939-1 C.B. (pt. 2) 332, 345-46.

⁴⁶ Revenue Act of 1926, ch. 27, §§ 204(b)(2), 214(a)(9), 234(a)(8), 44 Stat. 9, 16, 26-27, 41-43. Discovery value depletion continued to apply to other natural resources despite administrative difficulties.

⁴⁷ Revenue Act of 1932, ch. 209, § 114(b)(4), 47 Stat. 169, 202-03. The rate of percentage depletion was 5% for coal mines, 15% for metal mines, and 23% for sulphur mines.

⁴⁸ I.R.C. § 613(b) (1976); Revenue Act of 1951, Pub. L. No. 183, § 319, 65 Stat. 452, 497-98; Revenue Act of 1944, ch. 63, § 124, 58 Stat. 24, 44-46; Revenue Act of 1942, ch. 619, § 145, 56 Stat. 798, 840.

Unfortunately, the Supreme Court long failed to recognize clearly the essential change in the nature and purpose of depletion. As a result the Court—and lower courts following its lead—almost invariably began any analysis of whether a particular taxpayer had an economic interest with the maxim that the purpose of the depletion allowance was to permit the taxpayer to recoup his investment in the mineral, and that “the granting of an arbitrary deduction . . . of a percentage of gross income was in the interest of convenience and in no way altered the fundamental theory of the allowance.”⁴⁹

The continuing validity of this maxim has not been critically examined by the Court because it has long been considered a truism. It finds its seeds in *United States v. Dakota-Montana Oil Co.*,⁵⁰ where the Court, in analyzing whether the change from discovery value to percentage depletion changed the prior rule requiring capitalized intangible drilling costs to be recovered through depletion rather than depreciation, stated that the change in the method of calculating depletion was not intended to change the theory of depletion.⁵¹ That is quite true; the change from discovery value depletion to percentage depletion occurred long after the depletion allowance had ceased to be merely a method of cost recovery. The metamorphosis in the purpose of the depletion allowance was effected, first, by the allowance of discovery value depletion as opposed to cost depletion and, later, by the total abandonment of any limit on aggregate depletion. It is clear that the change to discovery value depletion was intended to change the purpose underlying the depletion allowance, and, regardless of intended purpose, the failure to limit aggregate depletion clearly changes its effect from a method of cost recovery to a preferential exemption from taxation of a portion of the income derived from the extraction of natural resources. The description of the depletion allowance in *United States v. Ludey* was therefore totally outdated by 1932. Nevertheless, until the

⁴⁹ *Helvering v. Bankline Oil Co.*, 303 U.S. at 267. See *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 602-03 (1946); *Usibelli v. Commissioner*, 229 F.2d 539, 542 (9th Cir. 1955). But see *Commissioner v. Southwest Exploration Co.*, 350 U.S. at 312.

⁵⁰ 288 U.S. 459 (1933).

⁵¹ *Id.* at 467.

recent indications in *Swank* that the allowance serves a broader purpose,⁵² courts have struggled to analyze depletion as a capital recovery concept, something that percentage depletion simply is not.

The shibboleth that percentage depletion is merely a capital recovery mechanism has tainted the formulation of the test of an economic interest, beginning with the landmark case of *Palmer v. Bender*. While that decision has been rightly hailed as a triumph of "factualism" over the conceptualism of applying "abstruse property law" to determine who was entitled to the depletion allowance,⁵³ the Court failed to break away from the conceptualism of depletion as a capital recovery provision, despite its seeming acknowledgment that the policy behind percentage depletion was to encourage the discovery of oil.⁵⁴

Palmer v. Bender involved taxpayers who conveyed all of their rights to a portion of a tract under an oil lease in exchange for a cash payment, an additional \$1,000,000 payable out of one-half of the first oil produced, and an excess royalty of one-eighth of all oil produced.⁵⁵ The issue was whether the transaction was a lease or a sale. If a lease, the taxpayer would be entitled to deduct discovery value depletion; if a sale, only cost recovery would be allowed.

The Court rejected the government's argument that concepts of property law were determinative, consistent with its earlier decision in *Lynch v. Alworth-Stephens Co.*,⁵⁶ where it permitted depletion to a lessee. Rather, the Court formulated its now classic test for determining entitlement to depletion:

The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any

⁵² See text accompanying notes 25-26 *supra* for a discussion of the Court's analysis in *Swank* of the policy underlying the depletion allowance.

⁵³ Sneed, *The Economic Interest—An Expanding Concept*, 35 TEX. L. REV. 307, 312-13 (1957).

⁵⁴ *Palmer v. Bender*, 287 U.S. at 558.

⁵⁵ *Id.* at 553-54.

⁵⁶ 267 U.S. 364 (1925).

form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.⁵⁷

The Court held that the taxpayers in *Palmer v. Bender* met the requirement of a capital investment in the oil in place even though they had not made an actual cash investment. Resorting to a legal fiction, the Court found that, consonant with the policy of percentage depletion to encourage the discovery of oil, the statute treated the value of the oil at the date of discovery as the investment.⁵⁸ Since at the time of discovery the taxpayers had "complete legal control of the oil in place," they had "acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute."⁵⁹ There has been no further significant critical judicial examination of the "investment" requirement since *Palmer v. Bender*, and it has become an extraneous word in the first part of the definition of an economic interest. Consequently, where there is an interest in the mineral in place, the first half of the test is met, notwithstanding the absence of any actual cash investment.⁶⁰ On the other hand, where there is no interest in the mineral in place, a related capitalized cash expenditure, even though an investment related to the extraction of the mineral, cannot give rise to an economic interest.⁶¹

⁵⁷ *Palmer v. Bender*, 287 U.S. at 557.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, illustrates the anomaly of the continued justification of the depletion allowance as a recovery of capital investment:

An allowance for depletion . . . is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted the capital is unimpaired. The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit.

Id. at 312. See text accompanying notes 81-84 *infra* for a discussion of *Southwest Exploration Co.* See also *Casey, The Economic Interest—Play It Again, Sam*, 24 TAX LAW. 129, 136-37 (1970).

⁶¹ *Parsons v. Smith*, 359 U.S. 215 (movable equipment); *Helvering v. Bankline Oil*

The criteria actually utilized by the Court to determine whether the taxpayer has an interest in minerals in place are elusive and amorphous.⁶² This difficulty is partly a creature of the statute that spawned it—section 611 grants the depletion allowance “according to the peculiar conditions in each case.”⁶³ It is also a child, however, of the blending of the two prongs of the economic interest test of *Palmer v. Bender* and the regulations. While the first half of the test requires an interest in the mineral in place, the second half of the test requires that the taxpayer look solely to income from the extraction of the mineral to recoup his capital investment. This requires not only that the taxpayer’s capital investment be recouped from income actually derived from extraction and sale of the mineral,⁶⁴ but also that there be no other possible source from which such income can be derived.⁶⁵ Since there is in fact no need for a capital investment, the test at first seems paradoxical. Thus, a better statement of the test would be that the depletion allowance is available with respect to income derived from the extraction and sale of a mineral deposit in which the taxpayer has an interest in place, but it is not available with respect to income so derived if the taxpayer’s right to income can be satisfied by income from another source.⁶⁶

Co., 303 U.S. 362 (processing plant); *Constantino v. Commissioner*, 445 F.2d 405 (3d Cir. 1971) (movable equipment); *United States v. Wade*, 381 F.2d 345 (5th Cir. 1967) (movable and immovable strip mining equipment); *McCall v. Commissioner*, 312 F.2d 699 (4th Cir. 1963) (movable equipment, deductible development expense, depreciable immovable improvements); *Food Mach. & Chem. Corp. v. United States*, 366 F.2d 1007 (Ct. Cl. 1966) (processing plant); *CBN Corp. v. United States*, 364 F.2d 393 (Ct. Cl. 1966) (processing plant). But see *Winters Coal Co. v. Commissioner*, 496 F.2d 995 (5th Cir. 1974) (discussed in text accompanying note 141 *infra*); *Victory Sand & Concrete, Inc. v. Commissioner*, 61 T.C. 407 (1974) (investment in riparian land essential to dredging sand and gravel from river supported economic interest in sand and gravel despite absence of exclusive legal right to remove sand and gravel from publicly owned river bed); *Oil City Sand & Gravel Co. v. Commissioner*, 32 T.C. 31 (1959) (same).

⁶² See generally *Sneed*, *supra* note 53, at 334-36.

⁶³ I.R.C. § 611(a) (1976). See *Food Mach. & Chem. Corp. v. United States*, 348 F.2d 921, 925-26 (Ct. Cl. 1965).

⁶⁴ Compare *Helvering v. Bankline Oil Co.*, 303 U.S. 362 with *Signal Gasoline Corp. v. Commissioner*, 77 F.2d 728 (9th Cir. 1935), *cert. denied*, 296 U.S. 657 (1936). See *Sneed*, *supra* note 53, at 320-27.

⁶⁵ *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 635; *Anderson v. Helvering*, 310 U.S. at 412-13. See *Parsons v. Smith*, 359 U.S. at 225.

⁶⁶ Other restatements of the test have also been advanced. One alternative is that the

Although the test for an economic interest is clearly stated as a two-pronged conjunctive test, considerations of the source of return often overlap with the determination of whether the taxpayer has the requisite interest in the minerals in place. Illustrative of such a blending is the analysis used by the Court in *Kirby Petroleum Co. v. Commissioner*⁶⁷ to determine whether a net profits interest was subject to depletion. Although the Commissioner conceded that the lessor taxpayer's royalty income based on gross receipts from oil extracted by the lessee was subject to depletion, he argued that a net profits interest did not represent an interest in the mineral in place. The Court concluded that a net profits royalty was theoretically no different from a gross receipts royalty, since the source of both payments was the proceeds from the sale of oil; consequently, title to the oil in place was not necessary to establish the existence of an economic interest.⁶⁸

That title to the oil in place was not a requisite for establishing an economic interest certainly was not new with *Kirby Petroleum Co.* Both *Palmer v. Bender* and *Lynch v. Alworth-Stephens Co.* had clearly dispensed with such a formalistic test. However, the Court's approach in *Kirby Petroleum Co.*, finding an interest in the mineral in place by reference to the source of return, was a departure from the tests used in those earlier cases, which determined the requisite interest in the mineral based

receipt of income from the extraction and sale of the mineral must diminish the value of the taxpayer's capital interest in property. See *Commissioner v. Southwest Exploration Co.*, 350 U.S. at 316; *Kirby Petroleum Co. v. Commissioner*, 326 U.S. at 603. One commentator has suggested that *Southwest Exploration Co.* warrants not only a restatement of the income test, but an entirely new test based solely on "income": "The 'interest' in production and sale is *ipso facto*, the 'interest' in the mineral in place—without production and sale there is no income, no depletion and no depletion allowance." Casey, *supra* note 60, at 136-37. Thus, if the receipt of income from production diminishes the present value of future income from production, the taxpayer has an economic interest. *Id.* at 137-38. This test is also suggested by *Kirby Petroleum Co.*

⁶⁷ 326 U.S. 599 (1946).

⁶⁸ *Id.* at 604. The Court stated that the "[l]essor's possibility of return depends upon oil extraction and ends with exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." *Id.*

upon the lessor's or lessee's control over the mineral.⁶⁹ There, the right to extract the mineral and reduce it to possession and ownership had been sufficient, even absent actual ownership of the mineral in the ground.⁷⁰ A similar test could easily have been applied in *Kirby Petroleum Co.* Because the lessor is the source of the lessee's control and the lessee's control is based upon compliance with the terms of the lease,⁷¹ the lessor clearly has retained control over the mineral deposit at the same time as the lessee. Such was the logic applied in *Burton-Sutton Oil Co. v. Commissioner*,⁷² decided after *Kirby*, holding that a net profits interest, even though not coupled with a royalty as it had been in *Kirby Petroleum Co.*, was an economic interest.

⁶⁹ The Supreme Court stated in *Palmer v. Bender*:

That the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted was recognized by this Court in *Lynch v. Alworth-Stephens Co.* . . . The statute made no specific reference to lessees. . . . But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease.

287 U.S. at 557. The Court relied on *Barnet v. Harmel*, 287 U.S. 103, for the proposition that a lessor is entitled to depletion on royalties received, and allowed depletion to the lessee-sublessor taxpayers in *Palmer v. Bender*. 287 U.S. at 557.

⁷⁰ *Lynch v. Alworth-Stephens Co.*, 267 U.S. at 370.

⁷¹ Under the doctrine of independent covenants the lessor's remedy for the lessee's breach of the covenants of a mining lease is an action for damages, unless there is an express forfeiture clause in the lease. 3 ROCKY MTN. MIN. L. FOUND., *AMERICAN LAW OF MINING* § 16.78 (1980) [hereinafter cited as *AMERICAN LAW OF MINING*]. Where an oil and gas lease is involved, the prevailing view appears to be that if damages are inadequate the lessor can obtain cancellation of the lease. R. HEMINGWAY, *THE LAW OF OIL AND GAS* § 8.10-8.11 (1971).

⁷² 328 U.S. 25 (1946). The Supreme Court stated as to the economic interest in this case:

Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control over the exploration of the land valuable benefits arising from and dependent upon the extraction of the oil, Congress provided as early as the Revenue Act of 1918 for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.

Id. at 33-34 (footnotes omitted). In this case, the assignor of the petitioner before assignment had an economic interest in the oil in place through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—50% of net income. *Id.*

The difficulty in considering the source of income to determine whether the taxpayer has an interest in the mineral in place is illustrated by *Helvering v. Bankline Oil Co.*,⁷³ decided eight years prior to *Kirby Petroleum Co.* The taxpayer in *Bankline Oil Co.*, pursuant to an agreement with the well owners, processed natural gas to remove the oil. The taxpayer paid the producers a royalty of one-third of gross receipts from the sale of the products derived from the purchased gas. It was clear that, but for the extraction and sale of the mineral product, the taxpayer would have had no income. Furthermore, because the royalty resulted in the taxpayer paying less than the fair market value for the unprocessed wet gas, the extra profit resulting from the "discount"—the only portion of its income on which the taxpayer claimed depletion—apparently resulted from some special relationship to the extraction and sale of the gas. Nevertheless, the Court held that the taxpayer did not have an economic interest, coining the "mere economic advantage" test now embraced in the regulations:⁷⁴

But the phrase "economic interest" is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit. . . .

. . . [A]part from its contracts with producers, respondent had no interest in the producing wells or in the wet gas in place.⁷⁵

The Court examined all of the taxpayer's expenditures and, finding that they were for equipment and facilities to deliver and process gas rather than for an interest in the gas, held that the taxpayer had no capital investment in the mineral in place.

Under the *Kirby Petroleum Co.* source-of-income analysis, however, the taxpayer in *Bankline Oil Co.* could probably be said to have income derived from the extraction and sale of the gas to the extent that the royalty paid did not equal the fair mar-

⁷³ 303 U.S. 362 (1938).

⁷⁴ Treas. Reg. § 1.611-1(b), T.D. 7261, 1973-1 C.B. 309, 317 (The text of § 1.611-1(b) is set forth in part at note 14 *supra*.).

⁷⁵ 303 U.S. at 367.

ket value of the gas.⁷⁶ When the deposit was exhausted the taxpayer would be compelled to seek new resources on the open market. If the production of the wells in question were reduced, the taxpayer's income would have been reduced by more than the lost profits attributable to processing an equal amount of wet gas purchased at fair market value. Therefore, the source of the taxpayer's profit attributable to the discounted purchase price was arguably the extraction and sale of the mineral rather than its purchase and sale, even though the balance was clearly derived from the resale of a processed mineral purchased after extraction. Thus, although the distinction between profits arising from extraction and sale of a mineral and profits arising from purchase and sale of a mineral is a crucial one which defeats many spurious claims of an economic interest,⁷⁷ it fails to provide the ultimate answer in *Bankline Oil Co.* To determine whether a taxpayer has an economic interest solely on the basis of the source of income is essentially to abandon both the requirement that the taxpayer have had some role in the exploration or development of the deposit—crudely contained in the first half of the test of an economic interest—and the requirement, however ephemeral, of an interest in the mineral in place.⁷⁸ This alternative has no clear tie to the policy basis behind percentage depletion.⁷⁹

To avoid this problem courts must revert to the first half of the definition of an economic interest, as did the Court in *Bankline Oil Co.* The difficulty with this formulation of the test is that the "capital investment" requirement is essentially meaningless because no true capital investment, in the form of an expendi-

⁷⁶ See *Signal Gasoline Corp. v. Commissioner*, 77 F.2d 728; Sneed, *supra* note 53, at 321-22.

⁷⁷ See G.C.M. 22730, 1941-1 C.B. 214.

⁷⁸ That this goal was only crudely served by the first half of the traditional definition of an economic interest is illustrated by the allowance, prior to the enactment of I.R.C. § 636 (1976), of a depletion deduction in a so-called "ABC" transaction to C, the purchaser of the retained production payment. See Hambrick, *Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction*, 34 GEO. WASH. L. REV. 1, 44-52 (1965).

⁷⁹ At least one commentator has suggested that the sole test for an economic interest and, hence, entitlement to the depletion allowance should be the source of income. The commentator acknowledges, however, the possible conflict with *Bankline Oil Co.* Casey, *supra* note 60, at 137-38.

ture, is necessary. A more suitable means of avoiding the finding of an economic interest in a situation not warranted by the policy underlying depletion, at least on the facts of the cases presently under discussion, lies in application of the control test. For example, although the taxpayer in *Bankline Oil Co.* had contractual rights to the gas once it was extracted by the producer, he had no control over the extraction of the mineral.⁸⁰ Therefore, exploration and discovery of new deposits would not be directly encouraged by allowing a depletion allowance to such a taxpayer.

The significance of control over the deposit was highlighted in *Commissioner v. Southwest Exploration Co.*,⁸¹ the first Supreme Court decision, and still one of a few decisions by a court of any level, holding that a taxpayer without an actual investment who had neither a fee nor a leasehold interest in the mineral deposit itself nevertheless had an economic interest. The issue in *Southwest Exploration Co.* was whether littoral land owners who granted an operating company rights to whipstock drill from their land to extract offshore deposits of oil were entitled to depletion against payments to them of 24.5% of the net profits. Under California law, offshore drilling was permitted only from wells drilled on filled land or slant drilled from upland sites. The operating company was required to provide evidence of the availability of the upland drilling site as a prerequisite to being awarded a bid. The Court characterized the upland owners' participation as the contribution of the "use of their land in return for rental based on the share of net profits" and "an investment in the oil in place sufficient to establish their economic interest."⁸²

The upland landowners, however, did not necessarily make an investment of capital the return of which could be realized only through depletion. They merely permitted the use of their land. If the original purchase price of their land did not reflect a premium arising from the value of controlling offshore drilling, any diminution in value caused by the depletion of the offshore oil would have been against unrealized appreciation in value.

⁸⁰ 303 U.S. at 368.

⁸¹ 350 U.S. 308 (1956).

⁸² *Id.* at 316.

Thus, diminution in value due solely to the extraction of oil would not have reduced the value of the land below the purchase price, and there was therefore no investment to be recouped.⁸³ If, on the other hand, the upland owners had paid a premium for the land due to its control over the ability to extract the offshore oil, there would have been a true investment.

This distinction, however, did not concern the Court. Even though there was no indication that the upland owners realized any diminution in value below purchase price by reason of the extraction of oil from whipstock wells drilled on their lands, their control over drilling was the key element in the Court's decision:

We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.⁸⁴

Thus, while the "contribution" of the upland owners was not necessarily a capital investment in the traditional sense, it is clear that such a contribution is not a prerequisite to obtaining an economic interest. *Southwest Exploration Co.* therefore emphasized the unique control of extraction held by the upland owners, a

⁸³ This is, of course, merely another example of the basic theoretical difficulty with percentage depletion, the implicit depletion of the discovery value of the deposit rather than the cost. See text accompanying note 46 *supra* for a discussion of the change from discovery value depletion to percentage depletion. Dean Griswold's comments on this point are particularly apt:

You say that percentage depletion is necessary to enable the industry to preserve its "capital." But this is obviously using capital in a double sense, and in a sense which is not applicable to other taxpayers. For other taxpayers, that capital, recoverable through depreciation, or on sale, or otherwise, is their investment in the property. Only in the oil business do "discoveries" become capital for tax purposes. Frankly, I find some trouble seeing why this should be so.

Baker & Griswold, *supra* note 43, at 370.

It is generally antithetical to our tax system to permit a deduction for a loss of unrealized gain. See I.R.C. §§ 165(b), 167(g) (1976) (limiting loss, bad debt, and depreciation deductions to the taxpayer's adjusted basis under I.R.C. § 1011 (1976), the starting point for which is generally the taxpayer's original cost, I.R.C. § 1012 (1976)).

⁸⁴ 350 U.S. at 317.

control usually held only by owners, lessors and lessees of the mineral deposit itself.

A. *The Impact of the Contract Miner Cases on the Palmer v. Bender Test*

Prior to *Parsons v. Smith*, there was substantial doubt regarding whether a contract miner had an economic interest. Many decisions held that he did have an economic interest,⁸⁵ but the import of the contract miner decisions prior to *Parsons v. Smith* is confusing, primarily because the Service often argued that a contract miner had an economic interest, thereby requiring the lessee or owner to deduct payments to the miner from the gross income from the property prior to computing his depletion allowance.⁸⁶ In other instances, however, the Service argued that the contract miner had no economic interest.⁸⁷ The distinguishing factor appears to have been whether the contract miner had the right to remove a substantial part of the mineral deposit.⁸⁸

In G.C.M. 26290,⁸⁹ the Service followed *Eastern Coal Corp. v. Yoke*⁹⁰ and held that the right to receive "a specified amount

⁸⁵ *Stilwell v. United States*, 250 F.2d 736 (4th Cir. 1957); *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (4th Cir. 1956), *rev'g*, 14 T.C.M. 218 (1955); *Usibelli v. Commissioner*, 229 F.2d 539; *Commissioner v. Mammoth Coal Co.*, 229 F.2d 535 (3d Cir. 1955), *rev'g*, 22 T.C. 571 (1954); *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir. 1954), *vacating and remanding* 19 T.C. 501 (1952); *Virginia B. Coal Co. v. Commissioner*, 25 T.C. 899 (1956); *Ruston v. Commissioner*, 19 T.C. 284 (1952). *See Weirton Ice & Coal Supply Co. v. Commissioner*, 231 F.2d 531 (4th Cir. 1956). *Contra Morrisdale Coal Mining Co. v. Commissioner*, 19 T.C. 208 (1952).

⁸⁶ *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (stripping contracts for 10- and 12-year terms); *Commissioner v. Mammoth Coal Co.*, 229 F.2d 535 (stripping contract for indefinite term); *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (stripping contract for all coal under particular tract); *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959) (stripping contract for term of one year, renewable); *Ruston v. Commissioner*, 19 T.C. 284 (stripping contract coterminous with lease); *Morrisdale Coal Mining Co. v. Commissioner*, 19 T.C. 208 (stripping contract for term of two years).

⁸⁷ *Weirton Ice & Coal Supply Co. v. Commissioner*, 231 F.2d 531 (contract to mine amount demanded by owner); *Usibelli v. Commissioner*, 229 F.2d 539 (contract to mine fixed tonnage); *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166 (N.D.W. Va. 1946) (contract for minimum tonnage).

⁸⁸ Compare cases cited in note 86 *supra* with cases cited in note 87 *supra*.

⁸⁹ 1950-1 C.B. 42, 44, *declared obsolete*, Rev. Rul. 70-277, 1970-1 C.B. 280.

⁹⁰ 67 F. Supp. 166 (N.D.W. Va. 1946).

per ton of mineral produced may constitute a right to share in production which marks ownership of a depletable economic interest in the mineral in place"⁹¹ by the contract miner. The right to a fixed sum per ton of coal mined and delivered met the second half of the test for an economic interest in that the contract miner was required to "look for his compensation solely to the extraction and sale of the mineral."⁹² To meet the first half of the test, i.e., that the contract miner acquire a capital interest in the mineral in place, the contract could not be terminable at will or upon relatively nominal—less than one year—notice.⁹³ This distinction is reasonably consonant with the control theory for analyzing the first half of the *Palmer v. Bender* definition of an economic interest. Although the Tax Court consistently held that the miner's right to a fixed payment per ton precluded the finding that the miner held an economic interest,⁹⁴ the courts of appeals followed G.C.M. 26290.⁹⁵

Since the decision of the Supreme Court in *Parsons v. Smith* and *Paragon Jewel Coal Co.*, the primary issue in so-called contract miner cases is to determine whether the operator is a contract miner or a lessee. If the operator is a contract miner, he has no economic interest, regardless of the term of the contract, and therefore no depletion allowance is available.⁹⁶ A lessee, on the other hand, has an economic interest, and the depletion allowance is available.⁹⁷

⁹¹ G.C.M. 26290, 1950-1 C.B. 42, 44.

⁹² *Id.* at 46.

⁹³ *Id.* at 45-46.

⁹⁴ Compare *Mammoth Coal Co. v. Commissioner*, 22 T.C. 571 (1954), *rev'd*, 229 F.2d 535 (3d Cir. 1956); *Gregory Run Coal Co. v. Commissioner*, 19 T.C. 501 (1952), *vacated and remanded*, 212 F.2d 52 (4th Cir. 1954), and *Morrisdale Coal Mining Co. v. Commissioner*, 19 T.C. 208 with *Denise Coal Co. v. Commissioner*, 29 T.C. 528 and *Virginia B. Coal Co. v. Commissioner*, 25 T.C. 899. *But see* *Weirton Ice & Coal Supply Co. v. Commissioner*, 24 T.C. 374 (1955), *rev'd*, 231 F.2d 531 (4th Cir. 1956).

⁹⁵ See cases cited at notes 85 and 94 *supra* for instances in which the courts of appeals followed G.C.M. 26290.

⁹⁶ *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 638; *Parsons v. Smith*, 359 U.S. at 224-26.

⁹⁷ Compare *Thornberry Constr. Co. v. United States*, 576 F.2d 346 (Ct. Cl. 1978) with *Douglas Coal Co. v. United States*, 429 F. Supp. 322 (N.D. W. Va. 1977) and *Bolling v. Commissioner*, 37 T.C. 754 (1962). In *Thornberry Constr. Co.*, the taxpayer-lessee strip-mined coal under a lease requiring him to fill the requirements of a third party desig-

Precisely what contractual terms characterized a contract miner, as opposed to a lessee, remained somewhat unclear for a short period. The seven factors indicating that the operator was a contract miner without an economic interest enumerated by the Court in *Parsons v. Smith* were

nated by the lease. The lessee independently negotiated a long-term requirements contract prior to the execution of the lease. The court found it irrelevant that the lessor would not have executed the lease if the sales contract had not been executed and held that the lessee was a true lessee having an economic interest and entitled to depletion.

What distinguishes this case from *Parsons v. Smith*, *supra*, and *Paragon Jewel Coal Co. v. Commissioner of Internal Revenue*, *supra*, (and from other cases cited by the defendant) is that, as a matter of form, of substance, and of economic reality, the lease and assignment conferred upon plaintiff the rights to mine coal and to sell that coal, at *whatever price it could obtain therefor*, to an independent, unrelated, third party (albeit a valued customer of AMAX itself).

576 F.2d at 353 (emphasis in original).

In *Bolling v. Commissioner* the taxpayer strip mined coal under a lease, terminable on 30 days' prior notice, in which the lessor reserved the right to purchase all coal mined at a "price . . . to be mutually agreed upon between the Lessor and the Lessee." 37 T.C. at 757. The lessor in fact purchased all coal production and retained extensive control over the method of operation. The court concluded that *Parsons v. Smith* could not be distinguished and held that the taxpayer did not have an economic interest.

Here . . . the petitioners engaged in their strip-mining operation under the contract completely subject to the will of Clinchfield, which had the right at any time to cancel the contract without cause upon the giving of 30 days' written notice. The language in the cancellation clause is unambiguous, and there is no merit in petitioners' argument seeking to distinguish the cancellation clause in this case from that involved in the *Parsons* and *Stallard* cases. . . .

Moreover, the 30-day cancellation clause is inconsistent with the petitioners' argument that they obtained a leasehold interest in the coal in place under their contract with Clinchfield. . . .

However, insofar as the contract provisions are concerned it would not be exactly correct to say, as was said in *Parsons* and *Stallard* that petitioners agreed to look only to the landowners for payment. Presumably Clinchfield could refuse to exercise its option or there could be failure to mutually agree as to price and there seems to be no provision forbidding sales of mined coal to third parties.

But . . . Cecil W. Bolling who negotiated the contract for the partnership testified it was his understanding that Clinchfield would take all of the coal at a price in line with what Clinchfield was paying other strippers in the area. . . . Under the circumstances we feel the absence of a binding contract compelling petitioners to look only to Clinchfield's payments for compensation is not sufficient basis to say petitioners gained an economic interest in the coal.

Id. at 764-65.

(1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even *after it was mined*, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]." ⁹⁸

It is somewhat difficult to assess the dimension added to the *Palmer v. Bender* definition of an economic interest by the seven factors in *Parsons v. Smith*. The first half of the definition is reflected in the first five factors of *Parsons v. Smith*, the fifth factor overlapping into both halves of the definition. These factors, however, are of little use in distinguishing a contract miner from a lessee. A lessee who has an economic interest often makes no actual capital investment in the mineral in place;⁹⁹ thus, he would have only the same fictional investment as was asserted by the

⁹⁸ 359 U.S. at 225 (emphasis added).

⁹⁹ See, e.g., *United States v. Swank*, 101 S. Ct. at 1933-34 (royalty per ton of coal produced, subject to annual minimum); *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946) (royalties due only on production; lessee covenanted to diligently explore and develop); *Winters Coal Co. v. Commissioner*, 496 F.2d 995 (subject to monthly minimum); *Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); *Bakertown Coal Co. v. United States*, 485 F.2d 633, 634 (Ct. Cl. 1973) (subject to qualified monthly minimum). Minimum royalties are frequently nominal in relation to the actual royalties paid based on production. See generally *AMERICAN LAW OF MINING*, *supra* note 71, at §§ 16.56-.57.

contractors in *Parsons v. Smith*. Frequently the lessee's sole investment is in depreciable equipment and deductible development expenses.¹⁰⁰ In addition, leases are often terminable on short notice without cause;¹⁰¹ yet, despite this similarity, the Court emphasized the short notice terminability factor as the most significant in concluding that the contract miners had no economic interest.

The portion of the fourth factor emphasizing that the landowners did not *agree* to surrender a capital interest in the coal in place begs the question. The particular form of the contractual agreement by which a taxpayer claiming the depletion allowance has acquired his rights is clearly irrelevant.¹⁰² Substance, not form, governs.¹⁰³ While the parties may structure respective substantive rights in order to create a capital interest in both or only one of the parties,¹⁰⁴ they cannot, by simply stating that a capital interest is or is not granted, effect that result.¹⁰⁵

The Court's reliance on "ownership" of the coal—the fifth factor—is also difficult to reconcile with previous pronouncements of the Court defining the parameters of the economic interest. In previous cases reliance on the niceties of title had been

¹⁰⁰ See, e.g., *Bakertown Coal Co. v. United States*, 485 F.2d at 634-35; *Mullins v. Commissioner*, 48 T.C. 571, 579 (1967).

¹⁰¹ See, e.g., *United States v. Swank*, 101 S. Ct. at 1933; *Winters Coal Co. v. Commissioner*, 496 F.2d at 996; *Whitner v. Commissioner*, 443 F.2d 170 (3d Cir. 1971); *Bakertown Coal Co. v. United States*, 485 F.2d at 634; *Weaver v. Commissioner*, 72 T.C. 594 (1979); *Mullins v. Commissioner*, 48 T.C. at 573-76.

¹⁰² *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. at 30; *Palmer v. Bender*, 287 U.S. at 557; *Burnet v. Harmel*, 287 U.S. at 111; *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364. *But see Helvering v. Elbe Oil Land Development Co.*, 303 U.S. 372.

¹⁰³ This is merely a specific application of the substance over form doctrine. For a general discussion of that doctrine see Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L.J. 693, 703-13 (1975).

¹⁰⁴ See Bulleit, *A Tax Incentive Approach to the Depletion Allowance Dilemma*, 82 W. VA. L. REV. 1115, 1130-34, 1137-38 (1980).

¹⁰⁵ In *Washburn v. Commissioner*, 44 T.C. 217 (1965), the contract between the contract miner and owner of the mineral rights specifically provided that the contractor had no economic interest, but the court apparently did not consider the effect of this provision, finding the facts so substantially similar to *Paragon Jewel Coal Co.* as to preclude a finding for the taxpayer. For a discussion of various substantive provisions in a contract between the owner of the mineral rights and a miner that will indicate whether an economic interest has been conveyed to the miner, see Bulleit, *supra* note 104, at 1130-34.

eschewed.¹⁰⁶ This principle is at the heart of the concept of economic interest: although legal title strongly indicates the presence of an economic interest, the absence of ownership, or even a legal estate, does not equally indicate the absence of an economic interest.¹⁰⁷

The sixth and seventh factors appeared to signal a strict view of the second half of the *Palmer v. Bender* test of an economic interest. Although the Court could have upheld the Service's attack on the contract miners' deduction on the sole ground that the short notice terminability of the contract precluded the taxpayers from meeting the first half of the test, the Court went far beyond this. It rejected the logic of *Eastern Coal Corp. v. Yoke*, accepted by the Service in G.C.M. 26290, and embraced instead the view of the Tax Court that payment to the contract miner of a fixed sum per ton of coal rather than a portion of the proceeds from the sale of the coal deprived the contractor of an economic interest.¹⁰⁸

Thus, the composite effect of the last three factors in *Parsons v. Smith*, when considered in terms of the definition of an economic interest, focuses on the second half of the definition. This result is difficult to reconcile with the established rule that a lessor who reserves a royalty requiring payment of a fixed sum per unit of mineral extracted retains an economic interest.¹⁰⁹

Parsons v. Smith clearly added further weight to the control theory of analyzing the first half of the definition of an economic interest. The factor of the most importance to the Court was the terminability of the contract on short notice without cause.¹¹⁰ As a result, the terminability of the contract miner's contract on

¹⁰⁶ E.g., *Commissioner v. Southwest Exploration Co.*, 350 U.S. at 315; *Palmer v. Bender*, 287 U.S. at 557; *Burnet v. Harmel*, 287 U.S. at 111; *Lynch v. Alworth-Stevens Co.*, 267 U.S. at 370.

¹⁰⁷ Sneed, *supra* note 53, at 336-37. Subsequent to *Parsons v. Smith*, Professor Sneed concluded that the Supreme Court had returned to an "ownership" test for an economic interest. Sneed, *Supreme Court Strip Mining Decisions Alter Tests for Depletable Interests*, 11 J. TAXN. 2 (1959). With the decision in *Swank*, it is clear that this is not so.

¹⁰⁸ *Parsons v. Smith*, 359 U.S. at 225.

¹⁰⁹ See Sneed, *supra* note 53, at 324. *But cf.* *Crowell Land & Mineral Corp. v. Commissioner*, 242 F.2d 864 (5th Cir. 1957) (agreement construed as a contract for sale rather than a mineral lease with an economic interest retained).

¹¹⁰ *McCall v. Commissioner*, 37 T.C. 674, 682-83 (1962), *aff'd*, 312 F.2d 699 (4th Cir. 1963).

short notice without cause became talismanic in some cases following *Parsons v. Smith*.¹¹¹ Other cases, however, did not focus solely on the factor of terminability but considered also the method of compensation.¹¹² The decision of the Supreme Court in *Paragon Jewel Coal Co.* indicated that those courts which emphasized both the method of compensation as well as terminability took the better view.

The issue in *Paragon Jewel Coal Co.* was essentially the same as that in *Parsons v. Smith*. In addition, the facts of the two cases were similar, except that in *Paragon Jewel Coal Co.* the contracts were oral and not expressly terminable, and the contract miners utilized drift mining rather than the strip mining method. The miners in *Paragon Jewel Coal Co.* consequently incurred substantially greater nonproductive expenses in opening the mines.¹¹³ Nevertheless, the Tax Court held that *Parsons v. Smith* controlled, finding that the contracts were in fact terminable at will and that the price paid to the miners was a fixed sum payment, despite the fact that the price *could change* from time to time depending on the general trend of the market.¹¹⁴ The Fourth Circuit reversed, concluding that the miners had a right to mine the coal to exhaustion at a price per ton that was "closely related" to the market price and, consequently, that the contract miners had an economic interest.¹¹⁵

The Supreme Court reversed the court of appeals, agreeing with the Tax Court that the contract miners did not have an economic interest in the coal. The Court emphasized the absence of a direct relationship between the price paid to the miners and the

¹¹¹ See *Elm Development Co. v. Commissioner*, 315 F.2d 488 (4th Cir. 1963) (allowing contract miner depletion allowance where contract was not terminable on short notice); *McCall v. Commissioner*, 312 F.2d 699; *United States v. Stallard*, 273 F.2d 847 (4th Cir. 1959) (denying contract miners depletion where contract terminable on short notice); *Utah Alloy Ores, Inc. v. Commissioner*, 33 T.C. 917 (1960).

¹¹² See *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959); *Merritt v. Commissioner*, 39 T.C. 257, 282 (1962), *rev'd*, 330 F.2d 161 (4th Cir.), *rev'd sub nom.* *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1964); *Legg v. Commissioner*, 39 T.C. 20 (1962).

¹¹³ 380 U.S. at 628-30.

¹¹⁴ *Merritt v. Commissioner*, 39 T.C. at 281-82.

¹¹⁵ *Merritt v. Commissioner*, 330 F.2d 161, 163 (4th Cir. 1964).

market price at which Paragon sold the coal.¹¹⁶ The miners received no percentage of the income from the sale of the coal; rather, they looked solely to Paragon for payment.¹¹⁷ Although the Court considered the terminability factor, concluding that the contracts were terminable at will, this factor was not dispositive. Indeed, the Court stated that even the "right to mine . . . to exhaustion, without more, does not constitute an economic interest under *Parsons*, but is a mere economic advantage. . . ."¹¹⁸ The *Paragon Jewel Coal Co.* decision, then, was based on the contract miners' failure to meet the test of the second half of the *Palmer v. Bender* definition of an economic interest embodied in the regulations.¹¹⁹ Thus, a person deriving income from a mining activity does not necessarily have an economic interest merely because he has a right to extract the mineral; he must also look solely to the extraction and sale at a price related to market price in some manner.

Although *Paragon Jewel Coal Co.* left unresolved the issue of the effect of a short notice termination provision on the first half of the test for an economic interest, terminability of their agreements on short notice remained one of the key elements cited by the lower courts in holding that contract miners did not have an economic interest.¹²⁰ Nevertheless, *Paragon Jewel Coal Co.* was followed in denying the depletion deduction to contract miners, even where their contracts were not terminable on short notice, if the contract called for a fixed sum payment for extraction of the mineral.¹²¹ Consequently, the method of compensation has now become the key factor in distinguishing contract miners from lessees. But *Paragon Jewel Coal Co.* clearly did not weaken

¹¹⁶ 380 U.S. at 635.

¹¹⁷ *Id.* at 635, 638.

¹¹⁸ *Id.* at 634.

¹¹⁹ See text accompanying note 108 *supra* for a discussion of the *Palmer v. Bender* test of an economic interest.

¹²⁰ *E.g.*, *Constantino v. Commissioner*, 445 F.2d 405; *United States v. Wade*, 381 F.2d 345; *United States Pipe & Foundry Co. v. Patterson*, 203 F. Supp. 335, 365 (N.D. Ala. 1962); *Ramey v. Commissioner*, 47 T.C. 363 (1967), *aff'd*, 398 F.2d 478 (6th Cir. 1965); *Washburn v. Commissioner*, 44 T.C. at 224.

¹²¹ *Denise Coal Co. v. Commissioner*, 271 F.2d 930; *Adkins v. Commissioner*, 51 T.C. 957 (1969).

the theory that control over the deposit is the key to satisfaction of the first half of the test for an economic interest.

B. *The Terminable Lease Cases and The First Half of the Palmer v. Bender Test*

It has been suggested that the genesis of the Internal Revenue Service position that the lessee under a lease terminable on short notice had no economic interest in the mineral in place lay in a misinterpretation by the Service of G.C.M. 26290.¹²² However, the dearth of any reported cases in which the Service asserted that position during the period between the promulgation of G.C.M. 26290 and the decision in *Parsons v. Smith* belies that suggestion. A more likely genesis of the position lies in the thrust of the opinion in *Parsons v. Smith*. The strong emphasis in that case on the terminable nature of the contract miners' rights as a basis for concluding that they had no economic interest almost inescapably leads to the conclusion that a lessee under a lease terminable on short notice without cause cannot meet the first half of the test, for unless there is an enforceable right to extract the mineral the first part of the test would be meaningless. Prior to *Parsons v. Smith*, other decisions of the Court had already clearly established that neither a cash investment in the mineral deposit nor legal title to the mineral before or after extraction was necessary to an economic interest. The only strain of consistency, therefore, was that the holder of an economic interest held an enforceable right to benefit from the deposit through the receipt of income as a result of the extraction of the mineral.

The Tax Court uniformly accepted the Commissioner's view in terminable lease cases.¹²³ The logic of the Tax Court position is best set forth in *Mullins v. Commissioner*.¹²⁴ That case involved three separate leases of the Blair, Clintwood, and Bolling coal

¹²² *Bakertown Coal Co. v. United States*, 485 F.2d at 636-37.

¹²³ *Weaver v. Commissioner*, 72 T.C. 594; *Winters Coal Co. v. Commissioner*, 57 T.C. 249 (1971), *rev'd*, 496 F.2d 995 (5th Cir. 1974); *Whitmer v. Commissioner*, 28 T.C.M. (C.C.H.) 1480 (1969), *aff'd*, 443 F.2d 170 (3d Cir. 1971); *Mullins v. Commissioner*, 48 T.C. 571; *Smoot v. Commissioner*, 25 B.T.A. 1038 (1932). *See also* *Holbrook v. Commissioner*, 65 T.C. 415 (1975) (terminable, non-exclusive license to extract minerals).

¹²⁴ 48 T.C. 571 (1967).

seams. The court found that the oral lease of the Blair seam was not terminable on short notice; the taxpayer had an enforceable right to mine the seam to exhaustion. The Clintwood lease was for a term of two years. The Bolling lease, however, was terminable on sixty days' notice. With respect to the Blair and Clintwood leases, the court held that the *Parsons v. Smith* factors indicated that the taxpayer had an economic interest in the mineral in place.¹²⁵ On the other hand, the court found no such economic interest in the taxpayer under the Bolling lease.

The sole basis of the court's holding in *Mullins* that the taxpayer had no economic interest in the coal in place under the Bolling lease was the termination clause. The court specifically found that none of the *Parsons v. Smith* disqualifying factors were present except the terminability of the lease and the resultant conclusion that the lessor had not surrendered a capital interest.¹²⁶ That the taxpayer could profit only from the sale of the coal and thus bore all of the benefits and burdens of market fluctuations was not sufficient to establish an economic interest. Because the terminability of the lease defeated any interest in the mineral in place, the taxpayer failed to satisfy the first half of the test. Thus, merely avoiding a majority of the *Parsons v. Smith* disqualifying factors was insufficient to avoid a determination that the taxpayer had no economic interest. Rather, the quality of the factors present was crucial:

While in both *Parsons* and *Paragon* the Supreme Court did not say which of the seven factors listed by it were absolutely essential in determining that the contractors had no economic interest, there is little doubt that in order to have a property right the contract lessee must have an interest which cannot be terminated at the will of the lessor or on short notice. . . . Only V.I.C. [the lessor], which in effect still had complete control over the coal in place through its right to terminate the Bolling lease without showing cause, possessed the qualifying depletable interest within the intendment of section 611.¹²⁷

¹²⁵ *Id.* at 579-82.

¹²⁶ *Id.* at 582-83.

¹²⁷ *Id.* at 583.

Despite the court's reference to a "property right," it seems clearly to have actually applied the control theory to determine whether the taxpayer had satisfied the first half of the economic interest test. The lessee failed to have an economic interest not because he lacked property rights under the lease, but because he had insufficient control. Although there is no doubt that under the niceties of property law the lessee did have a "property right" in at least some of the coal in place,¹²⁸ the court did not consider that right extensive enough to constitute an interest in the mineral in place. That the amount of coal which the miner could extract under the lease was a key element is reinforced by comparing the court's analysis of the two-year Clintwood lease. In that situation, the court said, the lessee had "sufficient time . . . to extract a substantial portion of the coal from that seam."¹²⁹

The theme of the extent of the lessee's right to extraction reappeared in the Tax Court's opinion in *Weaver v. Commissioner*.¹³⁰ In that case the court denied depletion to a lessee of sand and gravel deposits under a lease terminable at will by the lessor, but the lessee was allowed depletion under a lease terminable on 120 days' notice. The court said:

Clearly a line must be drawn somewhere between a cancellation clause with a notice so short that the lessee's market rights to mineral in place are for all practical purposes illusory, and a clause which leaves the lessee with substantive rights of genuine economic significance. The question is very close, and our record is not helpful in disclosing the economic potential of a guaranteed 120-day mining period. Nevertheless, like other close questions it must be decided, and we are of the view that a 120-day period of notice under the circumstances here was longer than nominal and had sufficient economic significance

¹²⁸ See *Bakertown Coal Co. v. United States*, 485 F.2d at 636. See generally AMERICAN LAW OF MINING, *supra* note 71, at §§ 16.10-.14.

¹²⁹ 48 T.C. at 580. The court referred to G.C.M. 26290, 1950-1 C.B. 42, 45, in this regard, thereby supporting the inference that the court was looking to the right to exhaust the deposit test sometimes asserted by the Service and applied in earlier cases. The right to exhaust the deposit without more was, however, deemed irrelevant two years earlier in *Paragon Jewel Coal Co.* See text accompanying note 116 *supra* for a discussion of the judicial history of *Paragon Jewel Coal Co.*

¹³⁰ 72 T.C. 594 (1979).

to give the petitioner a capital interest in the minerals in place, albeit a rather nominal one.¹³¹

There is no hint that niceties of property rights were considered. Rather, the key was the existence of "substantive rights of genuine economic significance."

The Tax Court view reflected an *ex ante* analysis of the formal substantive rights of the parties: the existence of an economic interest was determined by reference to the minimum rights to which the lessee may be entitled, rather than those he may have subsequently exercised. Chief Judge Drennen dissented in *Mullins*, applying an *ex post* test of substantive rights in contrast to the majority's *ex ante* approach.¹³² His dissent was a curious blend of policy and formal property law, which looked simply to whether the taxpayer had in fact extracted and sold the coal to determine entitlement to the depletion allowance. Since the lessee, according to the dissent, was the only person who could have any "gross income from mining," he should be entitled to depletion.¹³³ This approach, of course, emphasizes the second half of the test for an economic interest, treating the first half of the test almost as an unwarranted formalism required by courts. Consistently, the dissent approached the first half of the test in formalistic terms, treating the terminability provision as a mere possibility of divestment of an interest that has no effect unless exercised.¹³⁴

Judge Drennan's analysis was adopted by the Court of Claims in *Bakertown Coal Co. v. United States*,¹³⁵ which held that a lessee under a lease terminable on thirty days' notice had an economic interest in the mineral in place.¹³⁶ The Court of Claims, as had Judge Drennan in his dissent in *Mullins*, failed to analyze the lessee's rights under the *Palmer v. Bender* definition

¹³¹ *Id.* at 608-09.

¹³² 48 T.C. at 583-85 (Drennan, C.J., dissenting).

¹³³ *Id.* at 584. The dissent is technically incorrect in stating that the lessee was the only person who could have had any gross income from mining. Lessors of mineral property are allowed depletion (or capital gains if § 636 applies) on their royalties, and depletion is allowable only with respect to gross income from mining. I.R.C. § 613(a) (1976).

¹³⁴ 48 T.C. at 585.

¹³⁵ 485 F.2d 633 (Ct. Cl. 1973).

¹³⁶ *Id.* at 641.

of an economic interest. Instead, the court recited the *Parsons v. Smith* factors and concluded that *Paragon Jewel Coal Co.* limited the application of the terminability factor to contract miners.¹³⁷ The court refused to follow the Tax Court decisions, concluding that the Tax Court had erroneously applied the contract miner cases.¹³⁸ Later, the Court of Claims reached the same result in *Swank*, relying on its opinion in *Bakertown Coal Co.*

Although the *ex post* analysis reflects sound property law,¹³⁹ technical property rights cannot be unqualifiedly asserted as controlling principles under the *Palmer v. Bender* definition of an economic interest. Such an analysis does not vitiate the logic of *Mullins* refusing to find an economic interest in the coal in place where the lessee lacks control over the deposit; in such cases, the taxpayer has no right to mine any substantial amount of coal. To look retrospectively, as the *Mullins* dissent and the Court of Claims did, to find that the first half of the test is met because the lease was not in fact terminated, thus enabling the lessee to mine the coal under the lease for a substantial period, is to confuse the day-to-day right to extract the mineral with an ongoing right in the unextracted mineral. In this confusion, satisfaction of the second half of the test for an economic interest is transmuted into satisfaction of the first half.¹⁴⁰

Only two courts of appeals have been confronted with the issue of whether a lessee under a lease terminable on short notice has an economic interest in the mineral in place. The opinion of the Fifth Circuit reversing the Tax Court in *Winters Coal Co. v. Commissioner*¹⁴¹ did little to clarify the then-existing confusion. One judge concluded that the lessor's right to terminate the lease on thirty days' notice was clearly not sufficient to defeat the lessee's claim to an economic interest. In addition to following the *Bakertown Coal Co.* reasoning that the nature of a lessee's interest under property law is not altered by the existence of an unex-

¹³⁷ *Id.* at 638-39.

¹³⁸ *Id.* at 639-41. This view also finds support in P. BURKE & R. BOWHAY, INCOME TAXATION OF NATURAL RESOURCES 210-11 n. 32 (1979).

¹³⁹ 485 F.2d at 636.

¹⁴⁰ See text accompanying notes 67-80 *supra* for a discussion of the two-pronged conjunctive test.

¹⁴¹ 496 F.2d 995 (5th Cir. 1974), *rev'g* 57 T.C. 249 (1971).

exercised power of termination, the judge appears to have applied the *Parsons v. Smith* criteria without regard to either qualitative differences or to which half of the test each factor was directed.¹⁴² On the other hand, two judges were unwilling to uncategorically hold that a lessee under a terminable lease automatically had an interest in the mineral in place. Instead, they relied upon the fact that the lessee in *Winters* had purchased the surface rights necessary to strip mine the coal, applying *Southwest Exploration Co.* by analogy.¹⁴³ Once the lessee obtained the surface rights, he became an indispensable party to the removal of the coal, as had the upland owners in *Southwest Exploration Co.*, even though his right to extract the coal was terminable on thirty days' notice. The court totally ignored the logic that whatever interest was obtained by purchase of the surface rights, which could possibly justify depletion with respect to so much of the taxpayer's income attributable to the fair market value of periodic royalty payments in consideration of surface rights,¹⁴⁴ should not necessarily extend the taxpayer's economic interest to that portion of the taxpayer's income attributable to his active extraction and sale of the coal. Such income was not analogous to the income received by the upland owners in *Southwest Exploration Co.*

The other court of appeals decision was the Third Circuit's decision in *Whitmer v. Commissioner*.¹⁴⁵ Holding that a lessee under a lease terminable on thirty days' notice did not have an economic interest in the mineral in place because he failed the first half of the test, the court quoted *United States v. Stallard*,¹⁴⁶ stating:

Perhaps the most important [circumstances in determining whether a mineral producer possesses the requisite economic interest] is whether the producer has the right under the contract to exhaust the deposit to completion or is subject in this respect to the will of the owner through a provision in the

¹⁴² *Id.* at 998-99.

¹⁴³ *Id.* at 1000-01.

¹⁴⁴ See *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308; *Manchester Coal Co. v. Commissioner*, 24 B.T.A. 577 (1931). Cf. *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966) (equitable apportionment of actual cost).

¹⁴⁵ 443 F.2d 170 (3d Cir. 1971), *affg* 28 T.C.M. (C.C.H.) 1480.

¹⁴⁶ 273 F.2d 847 (4th Cir. 1959).

agreement empowering the owner to terminate the contract at will. . . .¹⁴⁷

This test—if it was indeed actually intended to be advanced as a test—only adds to the confusion. It has never been a general requisite of an economic interest that it be co-extensive with the life of a deposit; for example, production payments measurable in a fixed sum of dollars constitute an economic interest notwithstanding the absence of co-extensivity,¹⁴⁸ except as otherwise provided in section 636.¹⁴⁹ Indeed, there is no reason that an operating interest must be of sufficient duration to exhaust the deposit. Even prior to *Swank*, it was sufficient if the operator had a right to extract “a substantial portion of the deposit.”¹⁵⁰ Moreover, the mutually exclusive alternative of the Third Circuit is not broad enough to govern all possible lease arrangements. Such a test leaves unanswered the appropriate treatment of the lessee under a ten-year lease to extract mineral from a deposit which the parties do not expect to be exhausted for twenty years. The Service clearly would not have challenged the lessee’s claim of an economic interest under such a lease.¹⁵¹

Such was the confused state of the law regarding leases terminable on short notice prior to *Swank*. The Service and the Tax Court analyzed the substantive interests of the lessee and concluded that the first half of the test, requiring a capital interest in the mineral in place, could not be met if the lessee’s rights could be terminated without cause on short notice. Despite loose language in many cases to the contrary, a cash capital investment was not a prerequisite to holding a capital interest in the mineral in place.¹⁵² The *Parsons v. Smith* factors were analyzed qualita-

¹⁴⁷ 443 F.2d at 173 (quoting 273 F.2d at 851).

¹⁴⁸ *Thomas v. Perkins*, 201 U.S. 655 (1937). See generally Hambrick, *supra* note 78, at 38-44.

¹⁴⁹ See note 165 *infra* and accompanying text for a discussion of the treatment of production payments under I.R.C. § 636.

¹⁵⁰ G.C.M. 26290, 1950-1 C.B. 42, *declared obsolete*, Rev. Rul. 70-277, 1970-1 C.B. 280.

¹⁵¹ See *id.*

¹⁵² *Weaver v. Commissioner*, 72 T.C. at 605. Even the Tax Court seemed to believe that the taxpayer must have made some out-of-pocket expenditure associated with extracting the natural resource. But see *Winters Coal Co. v. Commissioner*, 496 F.2d 995 (discussed in text accompanying notes 141-44 *supra*.)

tively rather than quantitatively, and terminability was a key. The Service and the Tax Court may have differed, however, on the requisite minimum term of the lease. The Service generally considered that a term of at least one year was necessary. The Tax Court, on the other hand, found 120 days sufficient in *Weaver*, although since it deals with sand and gravel that case may not have the same relevance to a case involving coal mining.¹⁵³

The key to the Tax Court's theory that the lessee under a terminable lease had no capital interest in the mineral in place was that the lessor retained control of the mineral deposit through the power to terminate the lease; therefore, the rights of the lessee to the mineral in place were illusory and existed only with respect to extracted minerals. Although the Tax Court's theory comports nicely with the control theme of the landmark Supreme Court decisions, the divergent results in the case of a lease terminable on sixty days' notice in *Mullins* and one terminable on 120 days' notice in *Weaver* illustrate the difficulty in applying its theory. Although arbitrary rules are sometimes a necessity, so that divergent results are justifiable where the taxpayers' conduct falls on opposite sides of an imaginary dividing line, the different treatment resulting from the Tax Court theory seems difficult to justify. A simple example illustrates the problem: Lessee A enters into a five-year coal lease on January 1, 1980, subject to termination by the lessor at any time on sixty days' notice. Neither party at the time of execution contemplates that the lease will in fact be terminated and it is not so terminated. At the time of execution of the lease both the lessor and lessee contemplate that five years is insufficient to exhaust the deposit, and after five years the deposit has not in fact been substantially exhausted. Lessee B enters

¹⁵³ The *Weaver* court stated:

[W]e are of the view that a 120-day period of notice under the circumstances here was longer than nominal and had sufficient economic significance to give the petitioner a capital interest in the mineral in place . . . Each case must of course turn on its own facts. If in a given case it were shown that 120 days would be required simply to close down operations and that there would be insignificant production after notice were given, that would no doubt be a different matter.

72 T.C. at 608-09.

into a lease on the same terms as Lessee A except that the lease is terminable upon 120 days' prior notice. All of the other facts are the same. Under the Tax Court theory Lessee A had no economic interest and was not entitled to depletion, but Lessee B may have had an economic interest and thus may have been entitled to depletion. Such an arbitrary line is not justifiable.

While the result reached by the Tax Court seems to be unreasonable on policy grounds,¹⁵⁴ despite its sound logic when viewed from the control theory of a capital interest in minerals, the result reached by the Court of Claims cannot be squared with any notion of a capital interest in the mineral in place seemingly required by Supreme Court decisions prior to *Swank*. The Court of Claims' logic, while avoiding the arbitrary "cliff" effect of the Tax Court rule, was based solely on the factor that the lessee generated income from mining and selling coal on the open market.¹⁵⁵ Thus, if the lessee did not get the depletion allowance, no one would.¹⁵⁶ It simply seemed reasonable that someone should get the depletion allowance, and the lessee was the only person conceivably entitled to it. This, however, is a major policy argument which finds little basis for support in the definition and tests of an economic interest and is contrary to the Supreme Court's oft-repeated maxim that "[t]he deduction is . . . permitted as an act of grace. . . ."¹⁵⁷

C. *The Impact of Policy Considerations on the Early Cases*

How then do the putative and seemingly actual tests for the presence of an economic interest square with the policy underlying the depletion allowance? If the purpose of depletion is not merely to provide for a return of invested capital, but also to stimulate and encourage the exploration and development of new mineral deposits, what criteria should determine eligibility

¹⁵⁴ See *Palmer v. Bender*, 287 U.S. at 559. In *Palmer v. Bender*, the Court indicated that it would be anomalous to deny depletion completely and thereby defeat the purpose of the depletion allowance merely because of the form of the transaction.

¹⁵⁵ *Swank v. United States*, 602 F.2d at 353-54; *Bakertown Coal Co. v. United States*, 485 F.2d at 641.

¹⁵⁶ 602 F.2d at 351; 485 F.2d at 642.

¹⁵⁷ See, e.g., *Anderson v. Helvering*, 310 U.S. at 408.

for depletion? In other words, what factors should evidence the existence of the elusively defined but seemingly recognizable "economic interest"? Suggested standards include that the source of income is from the extraction of mineral,¹⁵⁸ that the taxpayer has made an investment of capital in the mineral in place,¹⁵⁹ that the taxpayer has legal or equitable title in the mineral in place,¹⁶⁰ or that the taxpayer has, or previously had, control over the mineral in place as owner, lessor, lessee, or a party having similar rights.¹⁶¹

It should be apparent that an actual capital investment in the mineral in place should entitle the investor to depletion realized upon the extraction of the mineral.¹⁶² The decisions are largely consistent with this theory. An actual prior investment alone, however, will not entitle the investor to depletion where the income is not from extraction and sale of the mineral but from the outright sale of the mineral property.¹⁶³ Similarly, a taxpayer having legal or equitable title to a mineral deposit should be entitled to depletion. He owns and controls a valuable resource, his consent to its extraction is necessary, and he will have acquired his title by virtue of investment in the deposit.

A mere right to income derived from the extraction of minerals, however, should not necessarily constitute an economic interest. Although permitting depletion against income derived as a result of the taxpayer's investment risk or contribution of effort in the exploration, development, and extraction of the mineral is consistent with the policy goals to be furthered,¹⁶⁴ a somewhat

¹⁵⁸ Casey, *supra* note 60, at 137-39.

¹⁵⁹ Bulleit, *supra* note 104, at 1134-36. It does not appear, however, that the author intended that the absence of an actual capital investment would preclude a taxpayer from having an economic interest. Thus an actual capital investment might be better described as evidence of an economic interest rather than as a prerequisite.

¹⁶⁰ Sneed, *supra* note 53, at 335. A similar test based on ownership of a real property interest in the mineral, as defined under state law, has also been suggested. Bulleit, *supra* note 104, at 1134-35.

¹⁶¹ Hambrick, *supra* note 78, at 21.

¹⁶² See Weaver v. Commissioner, 72 T.C. 594.

¹⁶³ Helvering v. Elbe Oil Land Dev. Corp., 303 U.S. 372 (1938). See I.R.C. § 636(b) (1976). See generally Hambrick, *supra* note 78, at 38-44.

¹⁶⁴ See Rev. Rul. 54-84, 1954-1 C.B. 284; Hambrick, *supra* note 78, at 22-25. Professor Hambrick argues that contributions to the operation and processing after the development stage should not give rise to an economic interest because the same risks are not in-

more difficult issue is presented when the taxpayer has not made such a contribution but has acquired a right to income from the extraction of the mineral in exchange for some other consideration. An illustration of this problem is the carved-out production payment, which is now specifically covered by section 636.¹⁶⁵ Treating the purchaser of a carved-out production payment—the purchase proceeds of which are pledged to exploration or development of the same mineral property—as holding an economic interest furthers the same policy goals as percentage depletion. Although there is no depletion benefit in allowing the transfer of an economic interest to the holder of the carved-out production payment, the transferor is allowed to amortize what is in effect a loan out of before-tax dollars.¹⁶⁶ If, however, the “loan” proceeds are not certainly to be devoted to exploration and development of new mineral resources, an unwarranted benefit would be granted if the “borrower” is permitted to amortize the loan principal out of before-tax dollars merely because he has earmarked income derived from the extraction of a mineral as a source of repayment. This is a greater advantage than is

volved. Although this position is clearly correct with respect to processing, see text accompanying notes 76-77 *supra*, the conclusion that operating risks are not to be rewarded by percentage depletion is not so clear. A lessee may in fact incur only operating risks, depending on the industry practices with respect to exploration and discovery. Nevertheless, a lessee-operator is clearly allowed depletion. Furthermore, the policy orientation of *Swank* clearly heralds that an operator's risk be rewarded. See *United States v. Swank*, 101 S. Ct. at 1939.

¹⁶⁵ I.R.C. § 636(a) (1976) provides:

A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. In the case of a production payment carved out for exploration or development of a mineral property, the preceding sentence shall apply only if and to the extent gross income from the property (for purposes of section 613) would be realized, in the absence of the application of such sentence, by the person creating the production payment.

Similar treatment as a mortgage loan is accorded retained production payments on the sale of mineral property by I.R.C. § 636(b) (1976), but under § 636(c) a retained production payment on a lease is treated as a bonus. See notes 227-29 *infra* and accompanying text for a discussion of the treatment of bonuses as depletable income.

¹⁶⁶ H.R. REP. NO. 413, 91st Cong., 1st Sess. (1969), reprinted in 1969-3 C.B. 200, 286-89; S. REP. NO. 552, 91st Cong., 1st Sess. (1969), reprinted in 1969-3 C.B. 423, 538-41.

necessary to encourage exploration and development of natural resources.

Situations also arise where the transaction is not analogous to a loan because the value of the assigned interest is not delimited by a dollar amount. In *Helvering v. O'Donnell*¹⁶⁷ the taxpayer received a net profits interest in certain oil leases in consideration of the transfer of stock of the corporation holding the leases. Because the transferor corporation, not the shareholder-taxpayer, owned the leases and the agreement did not grant the taxpayer a legal or equitable interest in the mineral properties themselves, the Supreme Court held that the taxpayer did not have an economic interest in the oil in place. The purchasing corporation merely promised to pay the taxpayer a portion of its profits. Although the argument was not discussed by the Court, it seems clear that the taxpayer could not claim that his net profits interest was received in consideration of his contribution to the exploration and development of the oil leases.

Consideration other than a contribution to exploration and development may, however, give rise to an economic interest if the income is derived from a legal or equitable interest in the mineral in place assigned to the taxpayer in consideration of such services. If a taxpayer is assigned an undivided share of the working interest in a mineral property, consideration in kind or in services should not be treated any differently than cash consideration.¹⁶⁸ If, however, the taxpayer acquires merely a royalty or net profits interest for consideration other than a contribution to the exploration and development, such as legal services to the operator or a royalty holder, the taxpayer should not have an economic interest.¹⁶⁹ Rather, he should have ordinary income equal to the value of the rights assigned, with no depletion allowed. The assignor of the income interest, analogous to the seller of a carved-out production payment, should not be permitted to pay for the nonessential services with before-tax dollars, the re-

¹⁶⁷ 303 U.S. 370 (1938).

¹⁶⁸ The person contributing such nonessential services would, of course, recognize ordinary income equal to the fair market value of the interest assigned to him. I.R.C. § 83 (1976).

¹⁶⁹ But see Sneed, *supra* note 53, at 354.

sult which would follow if the assignee were held to have an economic interest.

A similar analysis can be applied to *Bankline Oil Co.*, where the question was not which taxpayer was entitled to depletion, but whether any taxpayer could claim the allowance. Even if the taxpayer was denied depletion on the profits attributable to his bargain purchase of the mineral from the producer, the producer could nevertheless claim depletion only on the sales price to the taxpayer. Although it is reasonably clear that the taxpayer in *Bankline Oil Co.* derived income as a result of the extraction and sale of gas,¹⁷⁰ the decision that the taxpayer did not have an economic interest was correct. The taxpayer in *Bankline Oil Co.* made no greater contribution to the exploration and development of resources than does any other purchaser of a mineral resource who assures his supply through a long-term contract which simultaneously assures the seller of a market. If an electric utility company enters into a long-term contract with the owner-operator of a coal mine to supply coal to the utility at a fixed price, one could hardly say that the utility company has an interest that should give rise to depletion if the market value of coal rises above the contract price, but not if the market value is at or below the contract price.¹⁷¹ The utility's contribution to the development and exploration of the mineral resource is too remote.

Finally, one must ask how the control test for determining an interest in the mineral in place comports with the policy behind percentage depletion. It is self-evident that depletion should be available to an operator in control of the mineral property as a lessee or owner. But is it equally obvious that depletion should be available to the owner-lessor or sublessor¹⁷² who does not present-

¹⁷⁰ See text accompanying notes 76-79 *supra* for a discussion of the source-of-income analysis as applied to the *Bankline Oil Co.* taxpayer.

¹⁷¹ See *Douglas Coal Co. v. United States*, 429 F. Supp. at 338-39; *Thornberry Constr. Co. v. United States*, 576 F.2d 346; *Filtrol Corp. v. United States*, 487 F.2d 536 (Ct. Cl. 1973) (*per curiam*).

¹⁷² In the case of coal or iron ore, a lessor with a retained economic interest receives capital gain treatment with respect to the amount of royalties in excess of his cost basis instead of depletion. I.R.C. § 631(c) (Supp. III 1979). The issue is the same, however, since the purpose of § 631(c) was to provide lessors of coal and iron properties an even greater incentive than that provided by percentage depletion on royalties. See S. REP. NO. 781, 82d Cong., 1st Sess. (1951), *reprinted in* 1951-1 C.B. 458, 488.

ly control the extraction of the mineral if he has not made an actual cash investment¹⁷³ It is quite possible that the taxpayer has made no active contribution to the exploration and development of the mineral property. He has, however, made his property available for exploration and development to another person who is willing to undertake the risks. Without the lessor's surrender of control, removal of the mineral deposit is impossible. Therefore, income received in consideration of surrender of control should be treated identically with income received as a result of exercise of control. Furthermore, the lessor presumably has surrendered control over the deposit at a cost to the person undertaking exploration and development less than that which he would have demanded absent the availability of depletion to him as a lessor. This in turn may stimulate exploration and development by lessees of tracts which may not otherwise have been economically feasible to develop. Therefore, allowing depletion against royalty income seems to serve the policy goals of the depletion allowance.

It is anomalous, but not surprising given the general development of the economic interest theory in cases involving nonoperating interests, that some of the major problems in applying the definition of economic interest have arisen with respect to operating interests in certain hard mineral industries, particularly coal. The greatest difficulty in devising a test for an economic interest compatible with the policy behind percentage depletion arises with respect to contract miners in the coal industry, who neither make an actual investment in the acquisition of a traditional property right in the mineral in place nor acquire control over the mineral deposit. Contract miners, however, may invest large sums of money in equipment, which is often the most significant capital investment made in connection with the exploration, development, and extraction of the mineral. Further, the contract miner is integrally involved in the extraction of the min-

¹⁷³ Mineral leases often require only a nominal cash payment at execution; royalties are due only when there is production as long as exploration and development are diligently pursued. *See, e.g.,* *Burton-Sutton Oil Co. v. Commissioner*, 3 T.C. 1187 (1944), *aff'd*, 150 F.2d 621 (5th Cir. 1945), *rev'd and remanded*, 328 U.S. 25 (1946), *rev'd*, 168 F.2d 903 (5th Cir. 1946).

eral. His function is absolutely necessary, although as an individual he is theoretically fungible with all other persons having the same capital equipment and skills; no particular miner is indispensable. Nevertheless, the Supreme Court held in *Parsons v. Smith* and *Paragon Jewel Coal Co.* that contract miners do not have an economic interest: they have no interest in the mineral in place nor is their income derived from extraction and sale of the mineral.¹⁷⁴

The tax treatment of a contract miner stands in marked contrast to, for example, a sublessor holding an overriding royalty interest. A sublessor serves no necessary function in the sense that the owner could have extracted the mineral or hired someone else to do so, but, once having acquired the right to control the mineral deposit, the sublessor's cooperation and participation as an individual are required. A party in this position, therefore, always has an economic interest and is entitled to depletion, or capital gains in the case of coal and iron ore,¹⁷⁵ on his entire income.

Similarly, the lessee-operator, who combines the necessary function of the miner and the necessary person of the lessor, is permitted depletion with respect to his entire income from the property. However, it is not necessary that he actually extract the mineral. The lessee-operator may hire a contract miner. If he does, he is permitted the depletion allowance even with respect to the amount he pays the contract miner. If he extracts the mineral himself, however, a portion of his income is similar to that of the contract miner. Nevertheless, the economic interest akin to that of a lessor extends to allow depletion against his income derived from the same source as that of a contract miner. The different treatment of contract miners and lessee-operators can be justified only if percentage depletion is intended to encourage only discovery of mineral resources, rather than extraction. Such a postulate elevates the control theory to absolute primacy, keying depletion to the taxpayer making land he controls available for exploration. However, this is clearly not true. Rather, per-

¹⁷⁴ See text accompanying notes 85-121 *supra* for a detailed analysis these cases.

¹⁷⁵ See note 172 *supra* regarding capital gains treatment for coal and iron ore lessors under I.R.C. § 631 (c).

centage depletion is available only with reference to extraction of the mineral. Because depletion is intended to encourage participation in the extraction of natural resources, the elevation of the control theory to absolute primacy is not warranted.

A similar theoretical problem arises with respect to the lessee under a lease terminable without cause on short notice. With the exception of the short notice terminability, the lessee under such a lease is like any other lessee-operator and would thus be entitled to depletion with respect to his income from the property. For twenty years prior to *Swank*, however, the Service asserted that the short-term terminability of the lease precluded the lessee from holding an economic interest. Certainly, the terminability of a lease on short notice is substantially inconsistent with the control theory of determining an economic interest in the mineral in place. If the lease may be cancelled by the lessor on short notice and without cause, the lessee can hardly be said to control the deposit. He has limited control over the amount of the mineral which can be removed within the notice period. Thus, the lessor remains in control of the deposit. If one looks to the control concept in the general attribution of income rules, this retained control concept is readily apparent. An apt analogy is a trust for the benefit of another, revocable by the grantor on thirty days' prior notice; all the income of the trust is taxable to the grantor.¹⁷⁶ In the terminable lease cases, the unifying thread where a taxpayer was held to have an economic interest—the control doctrine—produces a result inconsistent with the purpose of the depletion allowance. There can be little doubt that a lessee actually operating a mine, regardless of the term of the lease, is precisely the type of person who should benefit from the depletion allowance if it is to fulfill its purpose.

III. THE DEFINITION OF ECONOMIC INTEREST AFTER SWANK

From a policy perspective, the Supreme Court reached a desirable result in *Swank*. To reach this result, however, the Court went beyond simply applying the traditional definition of an economic interest. The decision does not merely resolve the conflict among courts regarding the effect of a termination clause in the

¹⁷⁶ I.R.C. § 676 (1976).

lease by minimizing the importance of the terminability factor in the *Parsons v. Smith* criteria of an economic interest. Rather, it essentially rewrites the definition of an economic interest first set forth in *Palmer v. Bender* and long incorporated into the regulations. The logic of the Court's decision in *Swank*, if applied without restriction, goes even further than dispensing with the need for an actual investment in the mineral and totally dispenses with the need for any capital interest in the mineral in place.

Except by resorting to legal fictions to find a capital interest in the mineral in place for the purpose of reaching a result consonant with the policy underlying percentage depletion, the taxpayers in *Swank* could not have had an economic interest in the mineral in place as the theory was previously understood. There was no substance to their claim of a capital interest in the mineral because the taxpayers lacked legal or actual control over the deposits in place. The Court, however, found the argument that the only significant economic interest was controlled by the lessor to be unpersuasive for three reasons. First, the Court reasoned that the lessor would not necessarily terminate the lease and demand a higher royalty if the price of coal rose; that the lease was not in fact terminated or renegotiated in the face of rising coal prices belied such an argument. Second, it would be unfair to deny the taxpayer depletion merely because he had incurred a business risk in connection with the extraction of the coal not incurred by a lessee under a long-term lease. Finally, the Court concluded:

Third, and most important, the Government has not suggested any rational basis for linking the right to a depletion deduction to the period of time that the taxpayer operates a mine. If the authorization of a special tax benefit for mining a seam of coal to exhaustion is sound policy, that policy would seem equally sound whether the entire operation is conducted by one taxpayer over a prolonged period or by a series of taxpayers operating for successive shorter periods. The Government has suggested no reason why the efficient removal of a great quantity of coal in less than 30 days should have different tax consequences than the slower removal of the same quantity over the prolonged period.¹⁷⁷

¹⁷⁷ *United States v. Swank*, 101 S. Ct. at 1939.

The first two bases of the Court's rationale appear to be contradictory. If the lessor did not retain effective control, the lessee did not incur a risk of termination. If the lessee incurred a risk of termination, the lessor had not in fact surrendered control.¹⁷⁸

The third basis for the Court's holding, however, totally rejects the control theory of determining a capital interest in the mineral in place. The emphasis is instead on granting "a special tax benefit for mining a seam of coal." The Court did not merely reject the Service's proposed minimum duration of a lease; it rejected the notion that any minimum duration be required. Thus a lessee under a lease at will should be permitted the depletion allowance.¹⁷⁹ Surely, however, no one can reasonably say, except by resorting to the grossest of legal fictions, that the lessee under a lease terminable at the will of the lessor has any substantial effective control over or present interest in the unextracted mineral.

Silently, but at the core of the Court's decision in *Swank*, were the facts that the lessees were participating in the extraction and sale of the coal in an entrepreneurial capacity and that they had acquired control over the mineral once extracted.¹⁸⁰ The pol-

¹⁷⁸ Furthermore, the fact that the lessor did not terminate the lease in the face of rising coal prices does not indicate a lack of control. It merely indicates that the lessor made a business judgment that the risks of seeking a higher royalty were not warranted based on the change in price that had occurred. Surely there is a price level at which the lessor would have terminated the lease and demanded a higher royalty. See *id.* at 1944 (White, J., dissenting). The Court's rationale results in the lessor's having retained no control if the price of the coal does not increase significantly, but having control if the price of coal does increase significantly. This is a difficult argument to accept.

¹⁷⁹ But see *id.* at 1944 (White, J., dissenting). Under the Court's logic there would also be no reason to deny depletion to a person who extracted coal under a terminable non-exclusive license, as in *Holbrook v. Commissioner*, 65 T.C. 415.

¹⁸⁰ See 101 S. Ct. at 1944 (White, J., dissenting). In *Douglas Coal Co. v. United States*, 429 F. Supp. 322, the court used a similar analysis in applying the *Parsons v. Smith* criteria to determine whether an operator who leased coal property from an electric company and simultaneously contracted to sell the output to the electric company, under agreements having a five-year term, was a lessee or a contract miner. In holding that the operator was a lessee entitled to the depletion allowance, the court stated:

The Court has some general, conclusory comments about the *Parsons* criteria. It appears to this Court that the thread which ties the several *Parsons* criteria together is the basic question whether the coal operator assumed entrepreneurial-type obligations and risks with respect to the coal itself. That question can be answered in the affirmative. Douglas assumed all obligations with respect to the coal and its production.

icy goal of percentage depletion—to encourage the exploration, development, and extraction of natural resources—supported treatment of the lessees as holders of an economic interest. At the very least the lessees, even if lacking an interest in the mineral in place, acquired an interest upon extraction.¹⁸¹ Such an interpretation would be the narrowest possible reading of the relaxation of the test effected by *Swank*. This shift to a policy basis for determining an economic interest, however, calls for a broader test incorporating participation in the extraction or initial sale of the mineral in an entrepreneurial capacity as an alternative to requiring a capital interest in the mineral in place. Whether a taxpayer would satisfy this requirement would depend upon the particular facts and circumstances of each case.¹⁸²

The primary test for a depletable economic interest after *Swank* should be reliance by the taxpayer on extraction and sale of the mineral for the production of profit. This is essentially the second half of the *Palmer v. Bender* test, modified to reflect that a prior investment or capital interest to be recovered is not necessary. It is similar to the *Kirby Petroleum Co.* logic. However, *Swank* should not be read as simply reducing the definition of an economic interest to this single element or as merely rewriting the *Palmer v. Bender* test as a disjunctive rather than a conjunctive test. For a taxpayer to have an economic interest, his profit from the extraction and sale of a mineral should result from his role in the extraction and sale of the mineral.¹⁸³ Thus, the definition of an economic interest remains a two-part test.

Id. at 338. There is no indication as to how this entrepreneurial analysis would have been affected had the lease and sales contract been terminable on short notice.

¹⁸¹ See 101 S. Ct. at 1944 (White, J., dissenting) ("In essence, the Court argues that because respondents own the coal and sell it on the open market, they must have an interest in the mineral in place."); *Swank v. United States*, 602 F.2d at 353-54 ("The lessee's right under his lease to convert the lessor's legal title to minerals in place to his own possession by their severance constitutes a very real economic interest in the mineral in place which depletes as the minerals are extracted.").

¹⁸² See *Douglas Coal Co. v. United States*, 429 F. Supp. 322.

¹⁸³ If the test were either solely that the taxpayer relied on extraction and sale of the mineral for a profit or the *Palmer v. Bender* test rewritten in the disjunctive, the taxpayer in cases such as *O'Donnell* and *Bankline Oil Co.* would be found to have an economic interest. That result is not warranted by the policy orientation of *Swank*, which is directed solely to operating interests. See text accompanying notes 215-19 *infra* for further discussion of this issue.

The crucial question following *Swank* is the delineation of the second part of that test. The nature of the taxpayer's requisite relationship to the extraction of the mineral should be defined with reference to the policy behind percentage depletion. Although the *Swank* court acknowledged that percentage depletion is more than a mere device for the recovery of the cost of the mineral, it did not explain in detail what it perceived the policy considerations to be. Even absent specific guidance, it is probably safe to assume that as a general proposition depletion should be permitted, except as denied by statute, to any person connected with the extraction of minerals in an entrepreneurial capacity where the tax benefit will tend to encourage the exploration, development, or extraction of minerals. The thrust of the rationale for allowing depletion to the taxpayer in *Swank* was that he should be rewarded for incurring risks in the extraction and sale of coal.¹⁸⁴ This rationale comports with the entrepreneurial entitlement view of the depletion allowance. At the same time it must be recognized that entrepreneurial activity cannot be so elevated as to sacrifice the control theory when applied to nonoperating interests, which might be tested generally under the traditional test of *Palmer v. Bender*. This analysis suggests that the definition of an economic interest should continue to be a two-part test, but that it must now be modified. The first half of the new test for an economic interest should be whether the taxpayer's income is solely from the extraction and sale of the mineral. If that test is met, then either of two alternative tests must be met. Under the first alternative, the right to the income must be derived from a capital interest in the mineral in place—the traditional first half of the *Palmer v. Bender* test. Control of the mineral deposit remains the key theoretical element under this alternative. Under the second alternative, the right to the income must be derived from entrepreneurial activity in connection with the extraction and sale of the mineral. This alternative was the one met by the taxpayers in *Swank*. An examination of the application of this revised definition is appropriate to illustrate its effect upon the results of the earlier cases.

¹⁸⁴ 101 S. Ct. at 1939. See *id.* at 1944 (White, J., dissenting).

A. *The Contract Miner Cases Revisited*

Although many of the contract miner cases decided by the lower courts emphasized terminability as a basis for finding that the contract miner had no economic interest,¹⁸⁵ the *Swank* holding that terminability of a lease on short notice does not preclude an economic interest in the lessee was not intended by the Court to reverse *Parsons v. Smith* and *Paragon Jewel Coal Co.* The *Swank* opinion specifically states that the Court did not consider the terminability of the contract miners' rights in those cases to be the key factor.¹⁸⁶ Rather, the Court viewed the key factor in both *Parsons v. Smith* and *Paragon Jewel Coal Co.* to be that the contract miners received a fixed price for the coal they mined: they did not share the benefits and burdens of market fluctuations in the price of coal.

Although Justice White's dissent in *Swank* describes the majority's characterization of *Parsons v. Smith* and *Paragon Jewel Coal Co.* as an attempt to "rewrite those cases in light of what it determines to be the more important factor,"¹⁸⁷ this criticism is not entirely correct.¹⁸⁸ *Paragon Jewel Coal Co.* clearly held that a contract miner did not have an economic interest even if his rights were not terminable,¹⁸⁹ and lower court decisions frequently acknowledged that the basis for compensation was a key factor in denying a contract miner an economic interest.¹⁹⁰ Despite any "rewriting" of *Parsons v. Smith* and *Paragon Jewel Coal Co.* that

¹⁸⁵ See cases cited in notes 111 and 112 *supra* for cases dealing with this issue.

¹⁸⁶ 101 S. Ct. at 1938.

¹⁸⁷ *Id.* at 1944 (White, J., dissenting).

¹⁸⁸ The dissent was correct, however, that *Paragon Jewel Coal Co.* did nothing to vitiate the very strong inference of *Parsons v. Smith* that terminability of rights was per se fatal to any claim of an economic interest. See text accompanying note 118 *supra* for a discussion of the interrelationship of the rationale in *Parsons* and the decision in *Paragon Jewel Coal Co.*

¹⁸⁹ *Paragon Jewel Coal Co.* made it clear that, at least in that case, the contract miners did not have an economic interest because they failed the second half of the test of an economic interest. See text accompanying notes 116-18 *supra* for a discussion of the Court's treatment of this issue. Terminability of the contract rights, however, is a factor associated with determining whether the first half of the test has been met. See text accompanying notes 126-29 *supra* for a discussion of the relationship of terminability to the economic interest test.

¹⁹⁰ See cases cited in note 121 *supra* for examples of decisions denying depletion deductions to contract miners whose compensation was based on fixed sum payments.

may have occurred in *Swank*, the result in the contract miner cases is not obviously changed as a result of *Swank*. Contract miners who are paid a fixed fee per ton will continue to fail the second half of the *Palmer v. Bender* test which, as analyzed thus far, remains viable only as the first part of a restructured definition suggested in this article.

Justice White's analysis of the effect of *Swank* is correct, however, in an even broader sense than he intended. Based on a policy-oriented analysis, the decision of the Court in *Swank* not only effectively eliminated the necessity of satisfying the first half of the *Palmer v. Bender* test, permitting instead an alternative based on entrepreneurial involvement in the extraction of the coal, but also compels a re-examination of the second half of the *Palmer v. Bender* test, retained as the first half of the revised test proposed in this article. The dissent in *Swank* suggests that the majority's "focus on the marketing scheme as the test for determining whether a depletable allowance should be permitted is far less sensible than the Service's duration of the lease requirement."¹⁹¹ It may be, however, that neither focus is entirely appropriate.

Swank clearly signals that the policy underlying percentage depletion should be considered in determining entitlement to the allowance. While the purpose of percentage depletion is clearly to encourage the exploration, development, and extraction of mineral resources, keying entitlement to the allowance to the sale of the mineral is in theory inextricably linked to the outdated notion that the depletion allowance is a provision solely for recovery of capital. That the taxpayer's income does not vary with the market price of the natural resource should not therefore be a talismanic key to denying entitlement to the depletion allowance. Rather *Swank* recognizes that, from a policy perspective, income received as a result of entrepreneurial participation in the extraction of a mineral should be depletable, since such income has been earned by conducting the activity that percentage depletion is intended to encourage. Therefore, the test for an economic interest should be satisfied if a taxpayer realizes a profit as a result of the extraction of mineral and is entitled to receive that

¹⁹¹ 101 S. Ct. at 1944 (White, J., dissenting).

profit because of his entrepreneurial participation in the extraction. Profit resulting from the extraction of the mineral meets the first half of the proposed test, and entrepreneurial participation in the extraction meets the second half.

Under this theory many contract miners, including those involved in *Parsons v. Smith* and *Paragon Jewel Coal Co.*, should be entitled to depletion. In many instances the contract miners have clearly assumed an entrepreneurial role with respect to the extraction of the coal.¹⁹² They usually have a substantial invest-

¹⁹² For example, the contract between the lessee (Norma) and the strip miner (Rebecca) in *McCall v. Commissioner*, 312 F.2d 699, obligated the contract miner to:

(1) drive an entry into the seam at the designated place and to mine, by deep mining methods, all coal in that seam over a certain thickness; (2) mine the coal so as to produce the greatest quality of lump coal possible and deliver it to the screening plant or tippie of Norma; (3) conduct all mining operations in accord with the terms of the Youngstown lease, except as modified in the May 1, 1950 contract; (4) do all necessary work and provide all necessary materials, apparatus and labor for the mining operation; (5) produce a minimum of 50 tons of coal under normal conditions; (6) timber the mine and repair old timbering; (7) keep in repair the road and roadways from the mine to Norma's screening plant or tippie; (8) lay and construct all necessary mining tracks; (9) keep the mine drained and free from obstructions; (10) permit Norma to enter and inspect the premises; (11) comply with all mining and other applicable laws, both state and federal; and (12) carry Workmen's Compensation insurance and public liability insurance.

As consideration, Norma agreed to pay Rebecca \$4.00 per short ton for all coal mined and delivered, subject to change by mutual agreement, from time to time, as the coal market fluctuated.

Id. at 700. It is obvious that the contract miner was bearing a substantial risk because he had a large number of variable expenses which he might estimate, but of which he could not be certain, in negotiating the price per ton.

In *Commissioner v. Mammoth Coal Co.*, 229 F.2d 535, the owner was obligated to pay the strip miner only if he accepted the coal, reserving the right to reject any coal, upon which the miner was free to sell the rejected coal on its own account.

Substantial business risks were borne by the contract miner in *Paragon Jewel Coal Co.* Although the miners were paid only upon delivery of the coal, they were required to open the drift mine tunnels. It often takes six to eight weeks to develop such a mine to a point where it can be operated profitably. Furthermore, the nature of the coal deposits involved was such that the tunnels often hit large outcroppings of rock, which had to be removed before actual coal extraction could proceed. During this period, or when they were required to pump water out of flooded mines, the contract miners received no compensation, though they bore all of the expenses. *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 629-30.

See also *Ramey v. Commissioner*, 47 T.C. at 366-70; *Denise Coal Co. v. Commissioner*, 29 T.C. at 531-38.

ment in equipment,¹⁹³ and they have assumed an economic risk by dedicating, even temporarily, their equipment to mining. Where underground mining is involved and the contract miner bears the expense of developing the mine, the economic risk assumed is even more obvious than where strip mining is involved because of the considerably greater expense involved in opening up an underground mine.¹⁹⁴ Even in strip mining, however, the contractor must generally construct roads and prepare the site¹⁹⁵ and may be required to acquire necessary surface and wheelage rights.¹⁹⁶ That development expenses are fully deductible¹⁹⁷ and equipment and improvements depreciable¹⁹⁸ should be irrelevant.¹⁹⁹ All of these activities reflect entrepreneurial involve-

¹⁹³ See, e.g., *Parsons v. Smith*, 359 U.S. at 217, 219 (contract strip miners' investment in equipment as high as \$250,000 and \$500,000, respectively, in peak years); *United States v. Stallard*, 273 F.2d 847 (contract strip miner utilized depreciable movable equipment worth \$370,000); *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (contract strip miner purchased \$103,000 worth of movable equipment, in addition to equipment already owned, to perform under contract).

¹⁹⁴ See *McCall v. Commissioner*, 312 F.2d at 704-05.

¹⁹⁵ See, e.g., *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 628 (contract drift miners bore expenses of constructing tippie, power line, railroad siding and spurs, and road, as well as purchases of processing equipment); *Elm Dev. Co. v. Commissioner*, 315 F.2d at 489 (contract drift miner constructed roads and benches, the costs of which were currently deductible); *United States v. Stallard*, 273 F.2d 847 (contract strip miner expended between \$20,000 and \$25,000 to construct roads); *Denise Coal Co. v. Commissioner*, 271 F.2d at 939 (contract miner agreed to construct all roads and buildings necessary for the mining, removal, and transportation of the coal to railroad cars); *Commissioner v. Hamill Coal Corp.*, 239 F.2d 347 (contract strip miner constructed tippie and roads); *Adkins v. Commissioner*, 51 T.C. at 962 (drift miner bore all development and mining costs including opening the mines, building supporting structures, such as fan houses, powder houses, transformers, coal tipples, shoring, and roads).

¹⁹⁶ Cf. *Bolling v. Commissioner*, 37 T.C. at 757 (lease subject to termination on 30 days notice). More frequently, the lessor or owner is obligated to acquire the surface and wheelage rights. See, e.g., *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966); *Denise Coal Co. v. Commissioner*, 29 T.C. at 541-43.

¹⁹⁷ I.R.C. § 616 (1976). See *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 631. The cost of acquisition of surface rights by an operator with no economic interest represents a deduction rather than a capital item to be recovered through depletion. *Bolling v. Commissioner*, 37 T.C. at 764-65. See generally P. BURKE & R. BOWHAY, *supra* note 138, at ¶ 20.01-.12.

¹⁹⁸ I.R.C. § 167 (Supp. III 1979). See 380 U.S. at 631; *Choate v. Commissioner*, 324 U.S. 1 (1945). See also Whiteside & Jackson, *The Coal Operator's Depletion and Depreciation Deductions, OIL & GAS—NATURAL RESOURCES (P-H)* ¶ 2039, ¶ 2039.2 (1979).

¹⁹⁹ See *Eastern Coal Corp. v. Yoke*, 67 F. Supp. at 174. This logic, however, was rejected in *Parsons v. Smith*, 359 U.S. at 225. Nevertheless, in this regard a contract miner is

ment and can be distinguished from an employee or even a non-entrepreneurial contractor, i.e., one who contracts to supply only labor, using the lessee's or owner's equipment and with most major nonlabor expenses borne by the lessee or owner.²⁰⁰

That the contract miner receives a fixed price per ton of mineral extracted should be of no consequence. The *Swank* interpretation of *Parsons v. Smith* emphasizing the marketing risk is inappropriate. A lessee's or owner's risk of market fluctuations may be illusory; he may face little or no risk of frequent fluctuations where he has negotiated a long-term sales contract to sell coal at a fixed price, subject to adjustment if his costs increase.²⁰¹ The lessee in such circumstances may incur expenses related to the extraction of the coal only after the risk of an inability to sell has been eliminated.²⁰² Furthermore, in some instances he has not incurred any capital costs in acquiring the rights to the coal since

no different from a lessee. Exploration and development expenses are currently deductible by the lessee. Depreciation is claimed on all equipment and machinery and capital improvements. Expenditures for equipment necessary to maintain output because of recession of the working face of the mine are currently deductible if they neither increase the value of the mine nor decrease the cost of production and do not restore exhaustion of property for which a prior deduction has been allowed. Treas. Reg. § 1.612-2(a) (1960). Because royalties paid to the lessor are excluded from the lessee's gross income, the lessee has no capital investment to recover through depletion unless he has purchased the lease, see *Island Creek Coal Co. v. Commissioner*, 21 T.C.M. (C.C.H.) 727 (1962), or separately purchased surface rights, see *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966), or has paid the lessor a bonus. Treas. Reg. § 1.612-3(a)(3) (1960). See also *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (per curiam) (discussing ordinary and necessary expenses of strip mining versus capital expenditures); *Geoghegan & Mathis Inc. v. Commissioner*, 55 T.C. 672 (1971), *aff'd*, 453 F.2d 1324 (6th Cir. 1972), *cert. denied*, 409 U.S. 842 (1972) (reaching opposite result from *Kennecott Copper* on similar facts).

²⁰⁰ The retention of engineering control by the lessee or owner should be irrelevant. A lessee who operates a mine frequently does not have absolute engineering control; the lease often requires the lessor's approval of mining plans. Ross, *Coal and Coal Leases*, in OFFICE OF CONTINUING LEGAL EDUCATION, UNIVERSITY OF KENTUCKY COLLEGE OF LAW, REPORT OF SEMINAR ON MINERAL LAW 8 (1977) [hereinafter cited as *Coal and Coal Leases*].

²⁰¹ See, e.g., *Douglas Coal Co. v. United States*, 429 F. Supp. 322; *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166; *Thornberry Constr. Co. v. United States*, 576 F.2d 346; Rev. Rul. 73-32, 1973-1 C.B. 301. Cf. *Weirton Ice & Coal Supply Co. v. Commissioner*, 231 F.2d at 535 (owner-operator transferred coal property to customer and became contract miner to assure a profitable market for coal).

²⁰² See, e.g., 576 F.2d 346; Rev. Rul. 73-32, 1973-1 C.B. at 301.

royalties will be payable only as the coal is extracted and sold.²⁰³ To find that the lessee under such circumstances bears any substantial risks not often borne by contract miners is fictitious; nevertheless, a lessee will be found to have an economic interest under such circumstances.

It is equally fictitious to say that as a general rule only lessees or owners may benefit from price fluctuations. Although it is true that the contract price at which the lessee agrees to sell the coal is related to the market price of coal at the time the long-term contract is negotiated and executed, the fee received by the contract miner also bears some relationship to the general level of the market price at the time he commences work and sometimes fluctuates with the price of coal.²⁰⁴ Even if the contract price does not change with the market, as is also often the case,²⁰⁵ that the contract miner does not share in the market fluctuations should not preclude an economic interest. The lessor of mineral property frequently receives a fixed royalty per ton of mineral extracted over the term of the lease,²⁰⁶ yet he has an economic interest despite his insulation from market price fluctuations.²⁰⁷

²⁰³ See, e.g., *Thornberry Constr. Co. v. United States*, 576 F.2d 346. However, advance and minimum royalties are common in coal leases. Coggin, *Federal Income Tax Treatment of the Acquisition and Disposition of Coal Interests: An Examination of I.R.C. § 631(c)*, 82 W. VA. L. REV. 1139, 1156 (1980).

²⁰⁴ See, e.g., *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 628 (fixed contract price varied "depending somewhat on the general trend of the market price for the coal over extended periods and to some extent on labor costs"); *Constantino v. Commissioner*, 445 F.2d at 406 (contract miner was frequently paid more than contract price per ton); *McCall v. Commissioner*, 312 F.2d 699 (fixed contract price subject to change as market price fluctuated); *United States v. Stallard*, 273 F.2d 847 (same); *Adkins v. Commissioner*, 51 T.C. 957 (contract price to be adjusted in comparable ratio to substantial change in general price level); *Denise Coal Co. v. Commissioner*, 29 T.C. at 532, 535, 546 (fixed contract price subject to change if market price or lawful maximum price increased).

²⁰⁵ See, e.g., *Parsons v. Smith*, 359 U.S. at 217 (fixed contract price adjusted for increased labor and material costs pursuant to "understanding" of parties); *Elm Dev. Co. v. Commissioner*, 315 F.2d at 489 (contract miner's fee increased if union wages increased); *Commissioner v. Mammoth Coal Co.*, 229 F.2d 535 (adjustment in price due to fluctuations in wage levels); *Ramey v. Commissioner*, 47 T.C. at 374 (fixed contract price remained unchanged for six years despite market fluctuations).

²⁰⁶ H.R. REP. NO. 586, 82d Cong., 1st Sess. 30 (1951); *Whiteside & Gillis, Coal and Conservation—Tax Policy*, 64 Ky. L.J. 573, 582 (1975-76).

²⁰⁷ *Sneed*, *supra* note 53, at 335. See *Cline v. Commissioner*, 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980). Cline negotiated certain coal leases as an agent on be-

Nor should contract miners fail the test because technically they may look to the personal covenant of the owner or lessee for payment rather than to the sale of the coal. This holding of *Paragon Jewel Coal Co.* is inconsistent with the reasoning of *Swank*. In *Swank*, the Court gave scant attention to the lessee's lack of a prospective legal right to extract the mineral, emphasizing instead the expectations of the parties and their actual course of conduct.²⁰⁸ The lessee or owner expects to pay the contract miner out of proceeds from the sale of the coal, and the contract miner expects to be paid from those proceeds. Thus, the contract miner is in fact ultimately dependent upon the sale of the extracted coal as the source of his income; if the lessee cannot sell the coal, the contract miner might not be paid.²⁰⁹ Furthermore, unless a royalty holder takes his royalty in kind, he is in fact looking to the general funds of the lessee for payment; there is no requirement for the tracing of funds. Yet royalty payments have universally met the second half of the *Palmer v. Bender* test.

Obviously, the effect of allowing depletion to the contract miner would be to reduce the depletion allowable to the lessee or owner.²¹⁰ Merely permitting the contract miner to deduct depletion should not, however, subject the owner or lessee to section 631, since he remains a principal in the mining venture.²¹¹

half of a principal in consideration of a fixed sum royalty per ton of coal extracted from the leased properties. The Tax Court held that Cline had an economic interest with respect to the royalty. With inflationary pressures, however, there is a greater trend for lessors to negotiate for percentage royalties in mineral industries such as coal which historically often used fixed royalties. *Coal and Coal Leases*, *supra* note 200, at 6. Royalties with respect to oil and gas properties, on the other hand, have usually been expressed as a percentage of production or the proceeds from production.

²⁰⁸ 101 S. Ct. at 1938-39.

²⁰⁹ See *Commissioner v. Mammoth Coal Co.*, 229 F.2d at 538-39. *Contra Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. at 635.

²¹⁰ As a practical matter, the fee charged by contract miners may be generally reduced to reflect the lower tax burden on the contract miners and concomitant higher tax burden on the lessee or owner. The bargaining process includes consideration of tax benefits. Solocheck, *Elements of Taxation: Depletion*, in OFFICE OF CONTINUING LEGAL EDUCATION, UNIVERSITY OF KENTUCKY COLLEGE OF LAW, REPORT OF SEMINAR ON MINERAL LAW 56 (1976).

²¹¹ The provisions of § 631 do not apply to "income realized by any owner as a co-adventurer, partner, or principal in the mining of . . . coal . . . , and the word 'owner' means any person who owns an economic interest in coal . . . in place, including a sublessor." I.R.C. § 631(c) (Supp. III 1979). See *Paragon Jewel Coal Co. v. Commissioner*,

Rather, the operation should simply be viewed as more in the nature of a joint enterprise for the extraction and initial sale of the mineral, with the responsibility for different phases of the operation allocated between the parties.²¹² Each party should then be taxed on the income derived from the phase he conducts and should be allowed depletion against that income.²¹³

The owner or lessee of a mineral property mined by a contract miner is not in a position analogous to the taxpayer in *Bankline Oil Co.*, even though the lessee or owner is not actively engaged in the total extraction process. A key element in *Bankline Oil Co.* was the taxpayer's lack of control over production. In most instances involving contract miners, however, the owner or lessee retains control over the amount of production and mine engineering.²¹⁴ Furthermore, the owner or lessee originally had control over the deposit. Thus, his position with respect to income attributable to that control is analogous to that of the holder of a royalty. To the extent that the first half of the *Palmer v. Bender* test retains vitality as an alternative second test of the restated definition, that test would be met. In addition, that portion of his income attributable to the marketing of the extracted mineral must also be viewed as an inextricable part of the mining process, for without an initial sale there would be no purpose in extracting the mineral. Therefore, income derived from partic-

380 U.S. at 635-37. See generally Coggin, *Disposition of Coal Interests: Section 631(c)*, 29 TAX LAW. 95, 113-19 (1975).

²¹² This is analogous to the "joint efforts doctrine," under which the holder of a net profits interest in oil and gas property obtained in exchange for services contributing to exploration and development of the property does not have income on receipt of the interest and has a depletable economic interest in the oil in place. See Hambrick, *supra* note 78, at 21-28. See also Cline v. Commissioner, 67 T.C. 889; Rev. Rul. 77-84, 1977-1 C.B. 173.

²¹³ This was the taxpayer's argument in *Wade v. Commissioner*, 381 F.2d at 350, which was rejected by the court on the grounds that *Parsons v. Smith* was controlling.

²¹⁴ See, e.g., *Commissioner v. Mammoth Coal Co.*, 229 F.2d at 538 (owner retained power to suspend excavation operations); *Weirton Ice & Coal Supply Co. v. Commissioner*, 231 F.2d at 533 (contract miner to mine and deliver such quantities of coal as owner from time to time directed); *Usibelli v. Commissioner*, 229 F.2d at 540 (contract to mine fixed tonnage); *Ramey v. Commonwealth*, 47 T.C. at 367-69 (retained engineering control; option on output); *Bolling v. Commissioner*, 37 T.C. at 756-57 (retained engineering control; option on output); *McCall v. Commissioner*, 37 T.C. at 676-78 (retained engineering control; power to suspend operations and specify amount of coal to be mined). Cf. *Eastern Coal Corp. v. Yoke*, 67 F. Supp. at 168 (contract for fixed tonnage to be provided to sublessor by sublessee).

ipation as a principal in an entrepreneurial capacity in the initial sale of the mineral should also be depletable as having met the first half of the restated definition.

B. *Nonoperating Interests*

Nonoperating economic interests should be unaffected by the policy implications of *Swank*. Although *Swank* effectively dispenses with the necessity for control over the mineral deposit, it does not totally negate the significance of control. A taxpayer who would have met the *Palmer v. Bender* test for an economic interest should also meet the restated test. Care must be exercised in formulating the restated test, however, to avoid bringing within the sweep of the new definition interests for which the policy underpinnings of *Swank* do not warrant change in treatment. It is for this reason that *Swank* should not be read as merely eliminating the first half of the *Palmer v. Bender* test or as rewriting that definition in the disjunctive.

By dispensing with the need for capital interest in the mineral in place, *Swank* transmutes the second half of the *Palmer v. Bender* test to one based upon the taxpayer's having a possibility of profit solely from the extraction and sale of the mineral.²¹⁵ If the second half of the *Palmer v. Bender* test, as revised to comport with the theory of *Swank*, stood as the sole test for meeting the definition of an economic interest, a taxpayer such as the one in *Helvering v. O'Donnell*²¹⁶ would meet that half of the test and would therefore be entitled to depletion. Such a result should be avoided in constructing the revised test for an economic interest.²¹⁷ Similarly, a processor in the position of the taxpayer in *Bankline Oil Co.* would probably meet the first half of the restated test. However, *Swank* does not warrant finding an economic interest in a taxpayer in this position.²¹⁸ Although the tax-

²¹⁵ See text accompanying notes 180-84 *supra* for a discussion of the factors leading to this conclusion.

²¹⁶ 303 U.S. 370 (1938).

²¹⁷ See text accompanying note 167 *supra* for a discussion of why the nature of the taxpayer's interest in *Helvering v. O'Donnell* should not satisfy the requirements of an economic interest.

²¹⁸ Compare text accompanying note 170 *supra* with text at note 214 *supra* in regard

payer in *Bankline Oil Co.* would have had no profit but for the extraction and sale of the oil, his profit did not result from a contribution to the extraction and sale. A processor derives his profit from handling the extracted mineral, a crucial, if sometimes factually hazy, distinction.²¹⁹ Incorporating in the definition of an economic interest a requirement that the taxpayer's profit be derived from a contribution to the extraction of the mineral is essential to avoid unintentionally changing the result in cases such as *O'Donnell* and *Bankline Oil Co.*

An absolute requirement of a contribution to the extraction, however, might be interpreted to preclude nonoperating interests from the scope of the revised definition. To avoid this result, an alternative test should be available. In determining what the alternative should be, the thread of consistency in cases permitting depletion against income accruing to nonoperating interests provides the solution, i.e., that the holder of the interest currently holds or at one time held control over the mineral deposit.²²⁰ This concept was embodied in the first half of the *Palmer v. Bender* test, and retention of that concept as an alternative for satisfying the second half of the restated definition will assure consistent results in future cases regarding nonoperating interests.

The Supreme Court has had little difficulty in finding that royalty holders also meet the second half of the traditional test;²²¹ royalty holders should, therefore, meet the first half of the restated test. However, one must consider whether the first half of the revised definition—the second half of the *Palmer v. Bender*

to the relative lack of control over production by the taxpayer in *Bankline Oil Co.* compared to that exercised by the typical contract miner.

²¹⁹ See text accompanying notes 73-78 *supra* for a discussion of this distinction. Compare *CBN Corp. v. United States*, 364 F.2d 393 (Ct. Cl. 1966) (denying depletion deduction) with *CBN Corp. v. United States*, 328 F.2d 316 (Ct. Cl. 1964) (allowing depletion deduction in prior year governed by same contract which governed in later decision).

²²⁰ See text accompanying notes 53-84 *supra* for discussion of the importance of control in the development of the present economic interest test.

²²¹ See, e.g., *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308; *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (net profits interest); *Palmer v. Bender*, 287 U.S. 551; *Burnet v. Harmel*, 287 U.S. 103. The issue is barely discussed, if at all, since it is self-apparent that a royalty meets the second half of the *Palmer v. Bender* test if the first half has been met. Of course, this half of the test might not be met if there was an alternative source of payment. *Anderson v. Helvering*, 310 U.S. 404.

test revised to reflect that the taxpayer is looking solely to extraction and sale of the mineral for his profit rather than for a return of capital—will change the result in cases in which the taxpayer met the first half of the *Palmer v. Bender* test but failed the second half. In the context of nonoperating interests, the second half of the *Palmer v. Bender* test has not been examined as closely as the first half. Detailed analysis of the cases is unnecessary, however, due to the relatively minor change in regard to nonoperating interests which clearly have a capital interest in the mineral in place. The change from “return of investment” to “profit” is to achieve conformation to the restated first half of the test; no change has been made in the requirement that the sole source of income must be extraction of the mineral. Consequently, since the key issue in testing nonoperating interests against the second half of the *Palmer v. Bender* test has been the source of the receipt,²²² the revision should not affect the result in such cases.

*Anderson v. Helvering*²²³ is an illustrative case. The issue in *Anderson* was whether payments from the transferee to the transferor of certain mineral and fee interests were includible in the gross income of the transferee. Payment was to be made \$50,000 in cash and \$110,000 from one-half of the proceeds received by the transferee from oil and gas production and from the sale of the fee to any of the land transferred. The Court held that all of the income was included in the transferee's gross income. The transferor had no economic interest because he could look for his payments to a source other than production: he might instead be paid from the proceeds of the sale of the fee interest. Under the revised definition, this limitation remains effective so that the same result would be reached.

Where the sole source of the payments to the transferor is clearly the proceeds of production, however, *Anderson v. Helvering* would not be controlling and the issue must be determined by whether the transferor has retained an economic interest. Unless the transferor has conveyed all or a fractional share of his interest without retaining any continuing interest in production, or unless section 636 applies, the transaction will be treated

²²² See Sneed, *supra* note 53, at 318-34.

²²³ 310 U.S. 404 (1940).

as a lease and the source of the income therefore determined by reference to principles applied to lessors.²²⁴ Under these principles, the types of payments retained by a lessor are limited. A lessor will generally receive only royalties, advance royalties, bonuses, production payments, or delay rentals. Delay rentals are in the nature of rents rather than royalties and are clearly not depletable even if the lessor has retained an economic interest because the source of the payment was not the extraction and sale of a mineral.²²⁵ On the other hand, an ordinary royalty interest obviously meets this source requirement, and the same rule applies to advance royalties.²²⁶ A production payment is treated in the same manner as a bonus payable in installments.²²⁷ Although a bonus to a lessor does not reflect an economic interest under the logic of *Anderson v. Helovering* because it is not necessarily payable solely from the proceeds of the extraction and sale of the mineral,²²⁸ bonuses have been treated as depletable income.²²⁹ From the lessee's point of view, the theoretically correct analysis, requiring the lessee to include the bonus in gross income is followed.²³⁰ However, to prevent both the lessor and lessee from claiming percentage depletion with respect to the same income,

²²⁴ See F. BURKE & R. BOWHAY, *supra* note 138, at ¶ 3.02-.03. A conveyance of all or a fractional portion of the transferor's interest without any continuing interest in production is treated as a sale, which will normally generate capital gain under I.R.C. § 1231 (Supp. III 1979). A retained production payment on the sale of a mineral interest is treated as a purchase money mortgage loan under I.R.C. § 636(b) (1976) and not as an economic interest in the mineral property. The income from production used to satisfy the obligation is depletable ordinary income to the holder of the working interest.

²²⁵ Treas. Reg. § 1.612-3(c)(1) (1960).

²²⁶ Treas. Reg. § 1.612-3(b), T.D. 7523, 1978-1 C.B. 192, 194. If, however, the lessee's right to extract the mineral is abandoned or terminated before extraction of an amount of mineral attributable to the advance royalty paid, the lessor must restore to his capital account the depletion deductions attributable to the unextracted mineral and include a corresponding amount in income for the year of termination or abandonment.

²²⁷ I.R.C. § 636(c) (1976).

²²⁸ See Baker, *supra* note 41, at 272.

²²⁹ Treas. Reg. § 1.612-3, T.D. 7523, 1978-1 C.B. 192, 194. See *Burnet v. Harmel*, 287 U.S. 103.

²³⁰ See, e.g., *Murphy Corp. v. United States*, 230 F. Supp. 583 (W.D. Ark.), *aff'd per curiam*, 337 F.2d 677 (8th Cir. 1964). Treas. Reg. § 1.612-3(a)(3) (1960) treats the bonus as a capital investment made for the acquisition of a mineral interest, recoverable through depletion. See Treas. Reg. § 1.613-2(c)(5)(ii) (Ex. 1), T.D. 7261, 1973-1 C.B. 309, 317.

the lessee must exclude the amount of the bonus from gross income for purposes of computing percentage depletion.²³¹

The revised definition of an economic interest proposed in this article will not cause any change in these results. Clearly, all of the payments reflecting a retained economic interest will meet both the first half of the new test and the alternative of the second half of the new test derived from the first half of the *Palmer v. Bender* test. Conversely, the payments which do not reflect a retained economic interest will fail the revised test because they are not made solely by reason of extraction and sale of the mineral. Further, the inconsistent treatment of lease bonus payments is well established by both regulation and precedent, and its incongruity will similarly survive the revision of the definition of an economic interest.

C. *Broader Policy Perspectives*

The Court's recognition in *Swank* that percentage depletion serves an incentive policy goal and is not merely a cost recovery method exacerbates the policy problem created by treating percentage depletion as a substitute for cost depletion, thereby effectively denying actual recovery of capital expenses to taxpayers who have incurred them.²³² This is well illustrated by the situation of a lessee who has made a bonus payment. Although the lessee must capitalize the bonus payment and recover it through de-

²³¹ Treas. Reg. § 1.613-3(c)(5)(ii), T.D. 7261, 1973-1 C.B. 309, 317. It has been suggested that the lessee should be permitted to exclude the amount of the bonus from gross income for all purposes to achieve consistent treatment. *Canadian River Gas Co. v. Higgins*, 151 F.2d 954, 957 (2d Cir. 1945) (Hand, J., dissenting); Hambrick, *supra* note 78, at 35.

²³² See *Kennecott Copper Corp. v. United States*, 347 F.2d at 286 n.16 (per curiam) (acquisition of surface rights necessitated by expansion of strip mine pit held deductible operating expense, not capital expense recoverable only through depletion; taxpayer argued that because he had been claiming percentage depletion for many years and would continue to do so, capitalization of expense would effectively deny recovery). See also Miller, *Percentage Depletion and the Level of Domestic Mineral Production*, 15 NAT. RESOURCES J. 241, 253 (1975) (arguing that percentage depletion discourages exploration in the oil and gas industry because geological and geophysical expenses must be capitalized and are recoverable only through depletion unless they do not result in the acquisition of any property). For treatment of exploration expenses in the solid mineral industry, see I.R.C. § 617 (1976) and F. BURKE & R. BOWHAY, *supra* note 138, at ¶ 19.01-.11.

pletion, the lessee in most instances elects percentage depletion.²³³ Because percentage depletion is computed without reference to actual capital expenditures, he is effectively denied recovery of his capital expense. This can be simply illustrated by an example. Assume Lessee A leases coal property from Lessor A for ten years at a royalty of \$1.00 per ton of coal extracted. Both parties expect Lessee A to extract ten tons of coal per year. Lessee B leases coal property from Lessor B for a bonus of \$10.00 and a royalty of \$.90 per ton of coal extracted. Both parties expect Lessee B to extract ten tons of coal per year. Assume that both lessees incur \$5.00 of operating costs in each year and sell ten tons of coal at \$2.00 per ton. Lessee A has gross income from mining for purposes of computing percentage depletion of \$10.00. Lessee B, on the other hand, has gross income from mining of \$11.00. The taxable income of each would be computed as follows:

	Lessee A	Lessee B
Gross Income	\$10.00	\$11.00
Less operating expenses	5.00	5.00
Taxable Income before Depletion	5.00	6.00
Percentage Depletion	1.00	1.10
Taxable Income	4.00	4.90

Despite the fact that at the end of the ten-year lease both lessees would have identical aggregate, before-tax cash flow, Lessee A would have less aggregate taxable income because Lessee B would not be permitted to deduct the bonus payment, and his election to claim percentage depletion would preclude cost recovery of the capitalized bonus payment. A similar result can occur whenever a taxpayer who has incurred actual capital expenses against which cost depletion would be allowable elects percentage depletion.²³⁴

²³³ Miller, *supra* note 232, at 242.

²³⁴ See, e.g., *Geoghegan & Mathis v. Commissioner*, 453 F.2d 1324 (6th Cir. 1972), *aff'd* 55 T.C. 672 (1971), *cert. denied*, 409 U.S. 842 (1972) (disallowing deduction and requiring capitalization of cost of land on which to relocate pipeline easement necessitated by expansion of strip mine pit). *Contra* *Cushing Stone Co. v. United States*, 535 F.2d 27 (Ct. Cl. 1976). Compare *Manchester Coal Co. v. Commissioner*, 24 B.T.A. 577 with *Omer v. United States*, 329 F.2d 393 (acquisition of surface rights in fee simple must be capitalized and recovered through depletion but royalty payments for surface rights may be excludable from gross income of lessee because depletable income to lessor).

This disparity in treatment arises from the statutory pattern which views percentage depletion as an alternative to cost depletion. However, to treat percentage and cost depletion as mutually exclusive alternatives fails to recognize that percentage depletion, to the extent it exceeds the actual investment in the mineral property, serves a function substantially unrelated to cost recovery. Although percentage depletion, because it frequently exceeds cost depletion, has been defended as providing an incentive to exploration and development of mineral properties,²³⁵ treating cost and percentage depletion as alternatives imposes a competitive disadvantage in the form of a higher effective rate of taxation for taxpayers who have incurred greater capital expenses recoverable only through the depletion deduction.

Both equitable treatment and, assuming that percentage depletion does in fact have an incentive effect,²³⁶ implementation of the policy goals behind percentage depletion would be furthered by permitting both cost depletion and a reduction in the effective rate of taxation on income derived from the extraction of natural resources presently effected by percentage depletion. Allowing only actual cost depletion would restore the concept to its original function, i.e., a cost recovery method akin to cost of goods sold or depreciation. Allowing an exclusion of a certain percent-

²³⁵ E.g., R. CAMPBELL, PERCENTAGE DEPLETION AND EXPLORATION AND DEVELOPMENT COSTS, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 1041 (Comm. Print 1959); R. GONZALEZ, PERCENTAGE DEPLETION FOR PETROLEUM PRODUCTION, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 985 (Comm. Print 1959); H. JACKSON, DEPLETION AND EXPLORATION EXPENSES, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 1027 (Comm. Print 1959); L. RANDALL, DEPLETION AND EXPLORATION AND DEVELOPMENT COSTS OF THE MINING INDUSTRY, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 1033 (Comm. Print 1959); Baker & Griswold, *supra* note 43, at 361; McDonald, *Percentage Depletion and the Allocation of Resources: The Case of Oil and Gas*, 14 NAT'L TAX J. 323 (1961). Critics of percentage depletion have frequently acknowledged that it results in the attraction of capital to extractive industries and concomitantly greater production. E.g., P. STEINER, PERCENTAGE DEPLETION AND RESOURCE ALLOCATION, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 949 (Comm. Print 1959); Musgrave, *Another Look at Depletion*, 15 NAT'L TAX J. 205 (1962). See generally AGRIA, *Special Tax Treatment of Mineral Industries*, in THE TAXATION OF INCOME FROM CAPITAL 77-122 (A. Harbenger & M. Bailey eds. 1969).

²³⁶ It has also been suggested that percentage depletion actually provides only a minimal incentive effect. Miller, *supra* note 232, at 241.

age of the taxable income derived from the extraction and sale of natural resources would provide the same incentive that percentage depletion currently provides. Thus, treating the two issues separately will better assure horizontal equity for taxpayers engaged in the extraction of natural resources. Further, revising the structural relationship of cost depletion and the exclusion from taxation of income affected by percentage depletion should prompt re-examination of the relationship between the effective rate of taxation on income from the extraction of natural resources and the actual incentive to explore and develop natural resources provided by beneficial rates, as well as the equitable considerations inherent in permitting an advantageous rate of taxation to a particular industry.²³⁷

CONCLUSION

The test of an economic interest originating in *Palmer v. Bender* has traditionally consisted of two parts. First, the taxpayer must have acquired by investment a capital interest in the

²³⁷ No attempt will be made here to present or argue either side of these issues. The literature is replete with debates over the pros and cons of percentage depletion, both as to efficacy and fairness. See, e.g., C. GALVIN, *supra* note 41, at 933; H. GAY, TAX REFORM AND THE DEPLETION ALLOWANCE, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 979 (Comm. Print 1979); J. MENGE, THE ROLE OF TAXATION IN PROVIDING FOR DEPLETION OF MINERAL RESERVES, 2 HOUSE COMM. ON WAYS & MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM 967 (Comm. Print 1959); P. STEINER, *supra* note 235, at 949; Baker & Griswold, *supra* note 43, at 361; Davidson, *The Depletion Allowance Revisited*, 10 NAT. RESOURCES J. 1 (1970); Davidson, *Public Policy Problems of the Domestic Crude Industry*, 53 AM. ECON. REV. 85 (1963); Hause, *The Economic Consequences of Percentage Depletion Allowances*, 16 NATL. TAX J. 405 (1963); Kahn, *The Combined Effects of Prorating, the Depletion Allowance, and Import Quotas on the Cost of Producing Crude Oil in the United States*, 10 NAT. RES. J. 53 (1970); Kahn, *The Depletion Allowance in the Context of Cartelization*, 54 AM. ECON. REV. 286 (1964); Mead, *The System of Government Subsidies to the Oil Industry*, 10 NAT. RESOURCES J. 113 (1970); Miller, *supra* note 232, at 241.

There has already been a significant re-evaluation of the necessity for incentives provided by percentage depletion with respect to oil and gas. The Tax Reduction Act of 1975, Pub. L. No. 94-12 § 501, 89 Stat. 47-53 (codified at I.R.C. §§ 613(b), 613A, 703(a)(2) (1976) as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 190(a)(86)(A), 90 Stat. 1779, and the Energy Tax Act of 1978, Pub. L. No. 95-618, §§ 403(a)(2)(B), 403(b)(2), 92 Stat. 3202-04) repealed percentage depletion for all oil and gas production with limited exceptions. See generally F. BURKE & R. BOWHAY, *supra* note 138, at ¶8.14-.30.

mineral in place. Second, the taxpayer must have secured income derived solely from the extraction and sale of the mineral to which he looked for a return of his investment. The courts have long acknowledged that no actual investment was necessary to satisfy the first half of the test; merely obtaining a capital interest was sufficient. Accordingly, the second half of the test in reality required not that the taxpayer look to the income for a return of his investment, but that the extraction of the mineral that gave rise to the investment reduce the value of his capital interest. The test as so understood applied to all taxpayers having an economic interest in mineral properties.

In *United States v. Swank* the Supreme Court effectively rewrote the *Palmer v. Bender* test of an economic interest, *sub silencio* overturning the regulations incorporating that test. The theory of the *Swank* decision eliminates the need for a capital interest in the mineral in place and shifts the focus to an economic interest in the profits from the extraction and sale of the mineral. Primary attention is now directed to the second half of the test, which must also be altered as a result of the elimination of the requirement of a capital interest in the mineral in place. If no capital interest is necessary, the second half of the test cannot be predicated upon a diminution in the value of that capital interest. Rather, the second half of the test must now relate to profits: if the taxpayer looks solely to the extraction and sale of the mineral to make a profit, he may have an economic interest in the mineral.

A function previously served by the first half of the test was to limit depletion to those persons participating in extraction of the mineral rather than those whose profit is dependent on the extraction but who are not participating as operators or investors. This function can continue to be fulfilled by the second half of the revised test if the requisite relationship between profit from extraction and sale of the mineral and the taxpayer's contribution to the extraction is more clearly delineated. The existence of the requisite relationship can be found if the taxpayer meets either of two alternative tests. Both tests relate to the source from which the taxpayer derived the income that meets the first half of the test. The first alternative coincides with the traditional first half of the *Palmer v. Bender* test, which should

be shorn of its outdated "investment" element. Thus, if the taxpayer derives income solely from the extraction and sale of a natural resource and his right to that income is derived from a capital interest in the mineral in place, he will have an economic interest. Under this test, the results as to nonoperating interests will not differ from those previously achieved through application of the traditional test. Under the second alternative, a taxpayer having income derived solely from the extraction and sale of a natural resource should have an economic interest, even absent a capital interest in the mineral in place, if his right to the income is attributable to his participation in the extraction and sale in an entrepreneurial capacity. The major change wrought by this alternative is that it would treat most contract miners as having an economic interest entitling them to the depletion allowance.

Swank's emphasis on the policy behind percentage depletion and its conclusion that Congress could not have intended that under certain facts no taxpayer would be entitled to depletion calls for an even broader re-examination of the principles of depletion. Totally freeing entitlement to percentage depletion from any requirement of an investment or enforceable capital interest in the mineral in the ground renders anomalous the statutory patterns treating percentage and cost depletion as mutually exclusive alternatives. Because the result in *Swank* was consistent with the policy underlying percentage depletion, Congress should re-examine the present relationship between cost and percentage depletion. In doing so, cost depletion should always be allowed. Finally, if Congress concludes that it is appropriate to continue to encourage the exploration and development of natural resources through a reduction of the effective rate of taxation on income derived from their extraction and sale, it should enact a provision granting such a tax benefit in addition to, rather than in lieu of, cost depletion.

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